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A SYMPOSIUM ON THE 40TH ANNIVERSARY OF THE JOINT ECONOMIC COMMITTEE

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

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A SYMPOSIUM ON THE 40TH ANNIVERSARY OF THE JOINT ECONOMIC COMMITTEE

THURSDAY, JANUARY 16, 1986

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 345, Cannon House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Scheuer, and Wylie; and Senator Sarbanes.

OPENING REMARKS OF REPRESENTATIVE OBEY, CHAIRMAN

Chairman **OBEY**. Good morning. If I could have your attention, please, we will in the tradition of most committee hearings on Capitol Hill start this a mite late.

As you know, today's symposium marks the 40th anniversary of the Employment Act of 1946. Before we begin, I would like to introduce three people—and ask them to take a bow—in the audience who have had a great deal to do with the development of economic policy in this country over the last 40 years since the creation of both the Joint Economic Committee and the Council of Economic Advisers. I notice Henry Reuss in the room who, as you know, served as past chairman of this committee.

[Applause.]

Chairman **OBEY**. And I know that Dick Bolling is here who also served as a past chairman of the committee.

[Applause.]

Chairman **OBEY**. And Dr. Leon Keyserling who, as you know, was here when it all began and served as the first chairman of the Council of Economic Advisers.

[Applause.]

Chairman **OBEY**. And who along with the two other members I introduced has had an impact on the country's approach to economic thinking for a long, long time.

For those of you who are asking why are we holding this symposium this week, it is very simple. We have a new ruling in Congress under Gramm-Rudman which says that the Members of Congress who participate in this symposium this week do not have to deal with Gramm-Rudman for the rest of the year. [Laughter.]

As you know, the Employment Act of 1946 not only created the Joint Economic Committee and the Council on Economic Advisers, but it also formally acknowledged the responsibility of Government for promoting the growth of employment and output in the American economy. The act ratified the key lesson of the New Deal that our modern economy needed an effective economics to build the foundation necessary for private initiative to lift the economy on a sustained path of growth and prosperity.

The Employment Act grew out of a widespread fear that our economy would have difficulty managing the transition from war to peace without an effective and active effort on the part of the Government. The economy had grown at an incredible 12 percent per year under the stimulus of the Government's war-induced demand, and there was concern that demobilization would once again bring about a collapse of demand and throw us again back into a serious depression.

To help meet the challenge of demobilization, the Employment Act mandated that the Federal Government use "all practicable means" to "promote maximum employment, production, and purchasing power."

I have made available this morning a set of charts on the performance of the American economy for the last 40 years which show the progress we have made to date on the goals of maximum employment, production, and purchasing power.

The pattern is striking. On a whole range of key indicators, the American economy performed very well during the first two decades after the war, but fell off noticeably during the decade of the 1970's. In spite of some recent talk about the economy entering a new era of growth, the data suggest that today's policy regime has not reversed the 1970's pattern of uneven growth and persisting problems in our economic structure.

The strong performance of the American economy in the two decades after the war was neither an accident nor a matter of purely private initiative, although I'm sure we had our share of both. Instead, our enormous growth during that period was the product of good fortune in our economic circumstances combined with good sense in public policy.

We had the good fortune to emerge victorious and intact from a war which devastated the economies of the other major nations, but we also had the good sense to craft policies like the Marshall plan and the Bretton Woods monetary system which would foster growth in the rest of the world and create demand for American products.

We had the good fortune to welcome most of our servicemen back to the civilian economy, but had the good sense to provide them with the skills that they needed to be productive members of the new economy. The GI bill of rights and the National Defense Education Act assisted tens of millions of Americans in obtaining an education, and in the process gave the economy the skilled labor it so urgently needed. I myself would not be in Congress today if I had not been lucky enough to receive a graduate fellowship to study Russian Government under the NDEA. Don't ask me how that led me to the Joint Economic Committee.

We had the good fortune to see a strong progressive labor movement emerge in the context of the war effort, and the good sense to reinforce positive labor-management relations after the war with laws and practices which protected the rights of labor and provided for wage increases sufficiently large to purchase the output of industry.

We had the good fortune to discover the power of Government demand in promoting recovery, and then had the good sense to craft fiscal and monetary policies to maintain adequate private demand once the war was over.

We had the good fortune to be blessed with abundant and fertile farm land, and the good sense to put that land to ever more productive use. As a result, agricultural productivity in the postwar period grew at six times the rate of the previous 40 years.

In short, the policies of the 1950's and 1960's did a good job in meeting the challenges which that era presented. But the 1970's presented us with a new set of challenges which seemed beyond the reach of some of the old policies.

Inflation was the principal problem of the 1970's. Budget deficits resulting from President Johnson's failure to pay soon enough for the war in Vietnam left us poorly positioned to cope with two oil price shocks and a steep jump in food prices following the failure of the Soviet grain harvest. The assumption that wages should keep up with inflation quickly transformed those isolated shocks into a generalized level of inflation throughout the economy.

Faced with significant inflation, the old policies of active demand management appeared helpless. Traditional macroeconomics, trapped by the dismal logic of the Phillips curve, offered no cure for inflaton except deliberate recessions and higher unemployment to cool off the economy. Equipped with only this understanding of the problem, we wound up running macroeconomic policy in reverse, using fiscal and monetary tools not to promote growth but to induce recession. This was the infamous era of stop-go economics, as the economy lurched from inflation to credit crunch and back to inflation again.

Soon, even stop-go policies failed to produce growth and we repeated the late 1950's experience of producing both high unemployment and high inflation at the same time—the famous stagflation.

The failure of the existing policy regime to meet the challenge of the 1970's led to some extraordinary experiments in public policy. A Republican President, President Nixon, expanded the welfare system twice as fast as his Democratic predecessors as the private economy failed to generate sufficient jobs and income for the poor. That same Republican abandoned the gold standard and imposed wage and price controls, hardly conservative solutions and indicative of the confusion of the times.

Democrats fared no better. Jimmy Carter came to office on a promise to use both fiscal and monetary policy to stimulate growth sufficient to lower the unemployment rate from the intolerable figure of 7.5 percent. He left office after totally reversing course, with the Nation adopting an extraordinary restrictive monetary policy which created double-digit interest rates and still kept unemployment at unacceptably high levels.

The failure of both Democrats and Republicans to devise policies which effectively met the challenges of the 1970's set the stage for a radical policy departure in the 1980's. Rather than interpreting the 1970's as a period where policy failed to meet the challenge of reality, the Reagan administration appeared to blame the failures of the decade on policy itself.

In this formulation, the best public economics was no public economics. The President himself said: "Government is not the solution to our problem. Government is our problem."

Those views were supported by some apparent new departures in economic theory. Although monetarism and supply-side economics contradicted each other in crucial respects, they were fused into the theoretical foundations of the new economics. In retrospect, this radical departure has had some significant successes. Inflation was brought down dramatically and the country experienced a sense that things which had gotten out of control were now back in hand.

But those successes were purchased at a high price. Inflation was brought down, but despite the predictions of monetarism, only at the price of a recession longer and deeper than any since the 1930's. And the recovery from that recession was purchased with unprecedented increases in both budget and trade deficits, not the huge outpouring of growth and investment predicted by supply-side economics.

In the face of this mixed record, there is no point in rehashing the economic debate of the early 1980's about economic policy. It will change no minds. The important question for today's symposium and tomorrow's policy is: Where do we go from here? We need to disregard and discard old debates, comfortable partisanship and our own ideology, and face the fact that since the mid-1970's the economy has grown at a slower pace than before and that neither political party seems to have mastered the art of designing economic policies that will produce "maximum employment, production and purchasing power" without inflation.

The need to move on, the need to find a new set of economic policies has been dramatically intensified by the passage last year of the Gramm-Rudman amendment. Its passage signals I believe a widespread recognition that under the policies put in place in the previous years the "numbers really did not match," that today's policies are not living up to their promises. We can no longer paper over problems with mountains of debt and hand the next generation the bills for today's indulgence.

But while Gramm-Rudman calls a halt to the folly of present policy, it does not itself constitute any sort of solution to the economic challenges ahead. The bill closes off an old avenue for policy, but it does not by itself open up a new one. That new avenue can only be open if all of us—the President, the Congress, both political parties, and the economic leadership of this country—face the fact that the country cannot confront new realities with old political promises and old wishes.

While Gramm-Rudman would not have been the route that I would have followed to drive home the need for a new set of policies, I very much welcome the chance it provides to reopen the real debate about economics and economic policy.

I believe that an economy must achieve three basic goals if it is to be judged successful by a democratic society with America's set of values. First, it must produce an adequate and sustained rate of economic growth. Second, it must distribute the benefits of growth in a way which most citizens believe is fair. Third, it must provide opportunities for all individuals to realize their full human potential.

The first of those goals must be growth. Growth is essential for making the economy work in both a technical and a human sense. Strong growth makes it easier for an economy to adjust to the technological and competitive changes of modern life by transforming economic life from a zero-sum game in which I can win only if you lose, to a positive-sum game in which all can win if we all contribute to the recipe which will help expand the pie.

Strong growth produces rising incomes, and with it the sense of optimism and self-confidence which helps hold a society together. Growth demonstrates the country is working. It nurtures a spirit of generosity and caring about those less fortunate, and it helps to build the social consensus which keeps our society and Government working together.

The third world debt problem can only be resolved through strong growth in the world economy. And stronger growth at home and abroad is essential to an orderly reduction in the enormous Federal deficit.

Since the early 1970's, our economy has not enjoyed the kind of rapid growth we need. Last year, as everyone in this room knows, we managed to achieve only a 2.4 percent rate of growth in real GNP, and most predictions for the future are for a continuation of that trend roughly.

Weak growth produces a host of economic and social negatives. With slow growth, institutions become rigidly defensive, adjustment slows down, hope diminishes, opportunities contract, and people become fearful and anxious.

Slow growth imposes its greatest burdens on the young, who have not yet made a place for themselves in the economic structure. Recently, there has emerged a chorus of criticism of today's younger generation for being materialistic and selfish. They may be more materialistic. I do not know. Theologians and sociologists will have to determine that. But it is human nature to think more about yourself and less about your neighbor if a decade of slow economic growth seems to be squeezing your opportunity to provide things for your family you always thought were just around the corner.

Some examples. A young man leaving home in the 1950's and 1960's could expect by the age of 30 to be making roughly 30 percent more than the old man did when the kid left home. Today's 30-year-old on average would be making about 10 percent less than his father would have been making when that same young person left home and those younger workers are not experiencing the kind of vigorous earnings growth during the early part of their working lives that previous generations enjoyed.

When two wages don't seem to bring a family the same standard of living that one did 15 years ago, when young couples fight to be able to afford their first home, while seeing their parents locked into a 7-percent or 8-percent mortgage, and when 55 percent of kids living in single parent families are being brought up in poverty, it is no wonder that this generation thinks more about themselves than their neighbors. Our challenge is to broaden both their income opportunities and their field of vision.

But growth alone is not enough, not in this society. Successful economies also must manage to distribute the rewards of growth in a manner which citizens believe is fair and just.

The term "fairness" has taken a good deal of abuse recently, with pollsters telling us that most people take it as a codeword for "giveaways." But fairness is not synonymous with welfare, and we do ourselves a great disservice to dismiss the concept of fairness and justice from our discussions of economic policy.

To me, and to most Americans, a fair economy is one where rewards are distributed on the basis of hard work and where those willing to work can achieve a middle class standard of living.

But today it is getting harder and harder to earn a middle class standard of living. Real earnings fell steadily throughout the 1970's and have not rebounded sufficiently in the present recovery. The number of prime age individuals who work but are still poor has soared, increasing more than 60 percent since 1978.

At the other end of the income distribution, the rich who derive much of their income from the ownership of capital not from work, are expanding their share of national income. According to the Census Bureau, the gap between the richest American families and the poorest has widened in recent years, and now stands at its highest point since they began keeping statistics in 1946.

No one can make me believe that the American economy cannot be efficient without this much inequality. Nations such as Germany and Japan grew faster than we did during the period between 1960 and 1983 yet have far less inequality than we do. And our own period of most rapid growth came about when income disparities were less than they are today.

In fact, growing inequality undermines the social consensus and the political consensus, I would add, which is an essential prerequisite to growth. The divine right of property is no more sustainable in a democracy than the divine right of kings. Policies which pursue growth without regard to a fair distribution of both costs and benefits are likely to generate a populist resistance from those left out. That resistance will inevitably deny the country what it badly needs to plan and to prosper—continuity of policy.

Finally, a successful economy must meet the test of opportunity. Economic institutions are created to serve the needs of people, not the other way around. Successful economies are those which provide adequate opportunity for all citizens to realize their full potential as human beings, a realization which comes largely through work.

The ability to provide work for all who want it is thus the key test of a society's ability to deliver on the promise of opportunity. It is no accident that the act which gave rise to this symposium was called the Employment Act.

And by this standard, the United States still has a long way to go. Although the American economy has generated an impressive number of new jobs, we seem to be incapable of reducing the problem of unemployment or delivering on the promise of full employment. During each recession, the unemployment rate climbs to new highs, but each recovery leaves the unemployment rate higher than at the peak of the previous recovery.

Our inability to deliver on the promise of full employment has greatly complicated our dealings with the poor. We obviously cannot make the poor the central focus of economic policy, but the poor are human beings to whom, in the words of Willy Loman's wife, "some attention must be paid."

When a national news magazine such as Newsweek makes the homeless the subject of their cover story, can we truly ignore the fact that for too many people the world of Charles Dickens does not just exist in the Christmas Carol which we see yearly on our television sets during the Christmas holidays.

In the past, we have paid attention to those whom the economy left behind through welfare. And for many, the sick, the seriously disabled, there may be no alternatives except welfare. Not many deinstitutionalized mental patients will be browsing among the want ads for computer programming jobs or even for street sweeping opportunities. Yet we knew then and are even more certain now that, for most, welfare is a second-best solution. Increasing the ranks of the dependent is not good for the recipients or for the society.

The programs that worked to build a middle class America were opportunity programs, not welfare programs. It was only when we failed to deliver sufficient opportunity that we were forced to expand the ranks of the dependent. We need to renew our commitment to full employment and expanding opportunity or risk making America an economy that works only for those with sharp elbows.

Realizing the three goals of growth, fairness and opportunity will not be an easy task, the world of the 1980's and 1990's will present us with a new and complex set of challenges which must be met in order to reach these objectives.

We face the difficult challenge of reducing the massive Federal deficit without precipitating a recession or eliminating those Government programs which are essential to growth. But the challenges, however, are larger than simply getting our budget house in order. We certainly must do that, but we cannot allow Gramm-Rudman and the necessity of budget control to push us into a policy of disinvesting in things that can help this country grow.

We will need to meet the challenge of competition in an increasingly integrated world economy, or become a second-class economic power with a declining standard of living. We will need to meet the challenge of increasing the growth rate of the world economy, or face a crisis of insufficient demand, increasing protectionism, and unpayable debt. We must meet the challenge of increasing our own rate of productivity growth, improving the quality of our work force, and raising the incomes of our workers. We must find new ways of moving people from welfare to the work world, or we will cripple the humanity of welfare recipients and exhaust the patience of the taxpayer.

Meeting these challenges will require the active cooperation of all of our citizens and intelligent, effective partnership between the public and private sector, between workers and management. Economics is not just mathematics and models. It is also sociology and politics. It involves recognizing the importance of human motivation and acknowledging the economic importance of political decisions around the world. Policies which emphasize only market forces and individual self-interest cannot create the sense of social justice or define our true national interest in ways which will enable us to devise effective responses to the myriad challenges ahead.

Our past 5 years of experiment have proven that a purely private economics does not provide all the answers. To get the economy moving again and to keep it moving it is time to return to the spirit of creative pragmatism in the public sector which animated the Employment Act of 1946. It is time to move on to new arrangements which face new realities.

Previous waves of public creativity have brought us such conspicuous successes as the Marshall plan, the GI bill, the public highway system Social Security, unemployment insurance, Bretton Woods and the new economics of demand management which reduced the pain of recession.

It is time for another wave. It is time to once again search out, in the words of the Employment Act, "all practicable means" of achieving growth with equity, and prosperity with justice.

The purpose of this symposium is to listen to what some of the most thoughtful minds in the country have to tell us about how we ought to begin shaping public policy in the Gramm-Rudman era.

We do not claim to have every useful participant on the program. If we had, the program would run 2 weeks long. But we do have a reasonable mix of traditional and not so traditional points of view which will be expressed in the next 2 days to help us begin the task.

I thank all of the participants in advance for their willingness to participate and I thank you for your attendance today. At this point I would turn to Congressman Chalmers Wylie, the ranking House Republican on the committee, for any comments he might like to make.

[Applause.]

OPENING REMARKS OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you very much, Mr. Chairman. I think I'll save my economic remarks until the noon luncheon where you have afforded me the opportunity and privilege to introduce Messrs. Sprinkel and Rohatyn, but I would like to take this chance to congratulate you, Mr. Chairman, for initiating and bringing together this symposium to give public regard and recognition to the 40th anniversary of the Joint Economic Committee. I think the Joint Economic Committee deserves a birthday celebration and the occasion does afford a grand opportunity to take a current look at the American economy.

This is truly an all together 2-day event, Mr. Chairman, and I am anxious to listen to the distinguished panel which is coming up. I want to know how to go about reducing the deficit and I liked your remark where you think if we participate today that that ought to be as much as we ought to have to do as far as the Gramm-Rudman reducing the deficit is concerned.

But I think I'll take no more time right now, Mr. Chairman, and go to the panel, and thank you very much.

Chairman OBEY. Thank you, Mr. Wylie.

Next, Senator Sarbanes, who's serving at this session as the ranking Senate Democrat on the Joint Economic Committee.

OPENING REMARKS OF SENATOR SARBANES

Senator SARBANES. Mr. Chairman, I will be very brief, realizing that I'm on the House side and not the Senate side of the Capitol.

When the members of the Joint Economic Committee, under the very effective leadership of Chairman Obey, considered holding this symposium to mark the 40th anniversary of the committee, I don't think even at that point we fully anticipated how pertinent these sessions would be in light of the actions taken in the Congress over the last couple of months.

So I think we meet at a particularly important time. We're looking forward to the analysis, and the charting of the course for the future, that the panelists are going to make, and obviously, we have a very distinguished group of participants. I disagree with my chairman only to the point of saying that if we had everyone who was worthy it would require two months, not two weeks. That simply wasn't possible. But I join him in thanking those who have agreed to be part of this symposium.

We think this is a significant occasion. On numerous occasions over the course of four decades, the joint economic committee has provided important leadership in setting the course for the Nation's economic policies. I believe this symposium may represent an opening for a new endeavor of this nature on the committee's part.

Chairman OBEY. Thank you, Senator Sarbanes.

Congressman Scheuer, of New York.

OPENING REMARKS OF REPRESENTATIVE SCHEUER

Representative SCHEUER. Thank you, Mr. Chairman.

The prospect of hearing all the scheduled speakers is a very exciting one, but I think there's been an omission. I think we should have had some representatives of the occult sciences, black magic, to show us how to reduce this deficit, this horrendous $220 billion deficit, without resorting to revenue enhancement.

I think that we're going to get a lot of good advice today and guidelines. The question is, are we going to do the necessary? Are we going to pull our belts in a hitch, every segment of American society that's involved? Will consumers be willing to consume less and invest more? Our rate of consumption is a small fraction of that of our competitors overseas. We've got to consume less. We've got to invest more and our Government should be providing incentives like the Investment Tax Credit, like accelerated depreciation, for those areas of the economy that are in open and fierce competition with global competitors, and provide less incentives for investment in all kinds of real estate, hotels, apartments, high-rise office building and so forth that we don't need so much.

We ought to hope that industry can find a way of being more productive, of using whatever benefits we give them in the way of temporary protectionism to get their house in order, rather than ending up at the end of the protectionist period just as incapable of competing as they were at the beginning.

We have to convince industries such as steel where they have failed to invest over decades that the business of buying oil companies and engaging in all kinds of extracurricular investment activities is not central to their role and that we can't continue to bail them out and wrap them in a cocoon of protectionism to make up for their own policy decision shortcomings.

And we have to convince labor that they too must pull their belts in a hitch in areas of steel and autos where they're being paid twice the average industrial wage and twice the wage of their very effective competitors overseas, that they may have to understand that some adjustments are going to have to be made in their wage levels to prevent them from pricing their product out of global competition.

So once we learn what we have to do, it's going to take some national guts and some national will and some national determination for each segment of our society to pull in its belt a hitch and make the short-run sacrifices to achieve the long-run goals.

And finally, our government has to learn not only to get out of the way and stop harrassing this fantastic economic machinery that we've developed in the past but actually to provide some aids and some assists and some encouragement and some direction. That's a leadership challenge to the Congress as well as the administration. It certainly is a challenge to the JEC. I can't imagine a more challenging period in the last 40 years to have served on the JEC, on which I'm proud and happy to serve. I look forward to this symposium and let's see if we can get some of those occult sciences to help us.

Chairman OBEY. Thank you, Congressman Scheuer.

Now that you've finished hearing from the politicians, at least for the moment, we will turn to the meat of the program for the next 2 days.

I suppose it's fitting that 1 week before the Super Bowl in which the Chicago Bears will be participating that we have Gramm-Rudman which in effect is the new refrigerator of the American political system. I know that many people are hoping that the political leadership of this country will find a way to achieve a grand compromise on the budget so that we can avoid the draconian solutions that Gramm-Rudman otherwise implies.

We have a panel here today to try to provide us with some important analytical perspectives on the economics of deficit reduction. There are a number of questions which we need to ask ourselves. What should our deficit policy really be? What are appropriate deficit targets and under what circumstances? How should we measure them? What baseline should we start from in defining budget and deficit policies that relates to other fiscal factors?

To introduce today's panel and to moderate the next session, we have with us a person with a distinguished reputation in his own right. The moderator will be Hobart Rowen, who as I'm sure everyone knows is an economics reporter and syndicated columnist for the Washington Post. His column frequently helps shape the Washington debate on important economic issues and we certainly know on the political side how Bart feels when he feels that those of us on our side of the ledger have mucked it up. Bart Rowen.

PANEL: REDUCING THE DEFICIT: APPROPRIATE TARGETS AND EFFECTIVE MEANS—HOBART ROWEN, MODERATOR

Mr. ROWEN. Mr. Chairman, thank you very much. It feels somewhat awkward for me to be sitting here instead of at the press table where I belong, but you will all notice that Congressman Obey has had the foresight to prevent contamination either way by leaving one chair vacant between us on this side and those over there.

But seriously, I am honored to be a participant in this celebration of the 40th anniversary of the Employment Act of 1946 and to be here with so many of my old friends and colleagues such as Leon Keyserling, Dick Bolling, Henry Reuss, and others who worked on the committee, Grover Ensley and John Lehman, and let's not forget some of us old hands as reporters who covered the early days such as Lee Cohen who is sitting over there at the press table still today.

It seems to me listening to what Congressman Obey has said in his opening remarks that we are indeed a nation of extremists. We swing from excessive budget deficits to Gramm-Rudman, which invites us to balance the budget in an irrational way, I think, in a short six-year span.

What we're going to try to do, I gather, at these sessions is to try to throw some light on what some more reasonable approaches might be.

The subject matter of this first panel that we will get right into is "Reducing the Deficit: Appropriate Targets and Effective Means." We have five speakers. The pattern will be this: Each will take approximately 10 minutes and be guided by the green light which means "go," the yellow light which means "slow down," and the red light which means "please stop." We will then have an exchange among the panelists for perhaps 12 or 14 minutes and then we will take questions from the floor. I gather that you can write your questions out on cards which will be handed up here and then we'll sift through them and ask them.

Our first panelist is Robert Eisner, who is Kenan professor of economics at Northwestern University. He is the author of many articles on fiscal policy and other economic matters and he has a book coming out very shortly on this question of the Federal deficit.

PRESENTATION OF ROBERT EISNER

Mr. EISNER. Thank you very much.

There has always been a certain amount of public hysteria on the matter of Federal deficits and on the Federal debt. That hysteria can lead to some strange legislation, but hysteria is no substitute for knowing what we're talking about, what animal we have.

The fact is that deficits do matter. They matter perhaps in ways not always that well understood. Deficits can be too large; they can on certain occasions also be too small. But to know what to do about them, we have to measure them correctly. To begin with, we don't measure them in any economically meaningful fashion.

If the Federal Government method of accounting were applied by the large corporations of this country, almost every one of them would be showing a huge deficit along with its growing debt. The Federal Government also does not measure its deficit in any way like that of State and local governments.

The key issues are, first, that the Federal Government keeps no separate capital account. It's as if a private individual made no distinction between running a deficit and running into debt to finance gambling losses at Las Vegas and runing into debt in order to finance buying a house or for that matter the education of his children.

What's more, we make no adjustment for inflation. The consequence of that is the anomaly that we can have this Government running a deficit year after year and yet find the real Federal debt declining. I don't know how many of you have stopped to reflect upon the fact that with deficit after deficit in almost all of the years from 1945 to 1980 the real Federal debt per capita declined from some $4,000 to about $1,000 in 1972 dollars. In an economically real sense, we were not running deficits because we were not increasing the debt; we were reducing the debt.

Similarly, we think of our huge debt running some $2 trillion and yet the assets of the Federal Government, the tangible assets of buildings, equipment, roads, land, military equipment, inventories, come to some $2 trillion. In addition, the Federal Government and its affiliated agencies have financial assets of another $1 trillion.

In this sense then—and the public may not be aware of it—the Federal Government is not essentially different from private industry; and Federal Government too has a positive net worth. It has assets in excess of its liabilities.

The failure to understand this and to account properly for our debt and deficits leads to strange results. It leads to the notion that we can solve our deficit problem by in effect selling off the family jewels, by selling off our properties, by selling off our land, our resources, our dams, our loans. And I think all of you realize that those have turned out to be very live issues. That is presumably the way you can solve the problem of the deficit.

It reminds me of a story I quoted of a man—actually, my father-in-law used to tell this—who opened a law office in the depth of the depression and came back and told his wife, "I had a good day today, honey. I sold my desk." That's hardly a way really of meeting ones economic financial problems.

The fact that we have not accounted for the deficit correctly has led us to misunderstand our policy. It led indeed to some of the grievous failures in policy that we reflect upon. Those failures, I'd like to insist, were not really based upon a faulty economic theory or faulty understanding of the impact of deficits. They were based upon a failure to know just what we had.

I might add that deficits create debt and therefore they have an impact because the bigger the public debt, the more each of us as individuals through our pension funds and our businesses has in the way of assets, financial assets, which are the debt of the Government. The more we have in the way of those assets, the more we're likely to spend.

Now that's not always bad and that's why I say deficits can be too small. If we had a problem of unemployment, if we're not buying enough automobiles, television sets, other things to keep people at work, if we are wealthier because the Government owes us more, then we're likely to spend more. And if we try to reduce the debt in those circumstances, we are going to reduce spending and simply aggravate a recession.

On the other hand, of course, if we have a period of inflation due to excess demand or excess spending, then too big a deficit, too much of a public debt or too big an increase in it can cause trouble.

Now look at our recent economic history. In the Carter years, 1977 to 1980, the figures seem to show we had for them big deficits—finally reaching $60 billion—and we also had substantial inflation. And as pointed out, finally, by the end of the Carter administration, in the face of these apparent deficits, the administration supported a tight money policy and turned to a tight fiscal policy in order presumably to stop the inflation.

We seemed to think we had expansionary budget deficits, monetary policy initially was the only game in town, and we turned then to tight fiscal policy as well. The consequence was the greatest recession, the worst unemployment since the Great Depression.

Now, in fact, we did not have these big deficits. If you adjust for this inflation tax, adjust for what's happening to the real value of the Government debt to the public, you find that the Carter years—and this was misunderstood by friend and foe alike—the Carter years were not years of excessive fiscal stimulus; they were years of fiscal tightness. In a real, adjusted, corrected sense, corrected for inflation, those budget deficits were budget surpluses.

It was no wonder then that when the Reagan administration in effect pursued those policies for the next year or so, the recession really came on and we went to 10.8 percent unemployment. Then, despite the avowal that Government is the problem and not the solution, the Reagan administration switched completely with the tax cuts, and with the reduction of the inflation tax due to the reduction in inflation, we had a huge amount of stimulus. It should be no surprise that from the worst recession we switched to a very sharp recovery.

Where does that analysis leave us now? Our deficits probably are too large, by any measure, even with my inflation adjustment. On the other hand, we still have almost 7 percent umemployment. If we are going to reduce deficits—and we should at this point—we should have an accompanying monetary policy which stimulates demand sufficiently to further reduce unemployment.

But finally, what can you make of the situation we have in terms of Gramm-Rudman? There we are promised a balanced budget. But what kind of a balanced budget? A budget balanced by official measure! And a budget balanced by official measure would be a budget in huge surplus when you account for matters correctly. That budget in huge surplus—if we ever really carried it through—threatens the worst economic disaster that we've had in many a year.

[The complete presentation of Mr. Eisner follows:]

Congress of the United States
Joint Economic Committee

A Symposium on the Fortieth Anniversary of the
Joint Economic Committee

The American Economy in Transition:
from the Second World War to the 21st Century

"Reducing the Deficit: Appropriate Targets and Effective Means"

THE REAL FEDERAL DEFICIT

Robert Eisner
Northwestern University

Janury 16, 1986

January 8, 1986

The Real Federal Deficit

Robert Eisner*

There has always been a certain amount of hysteria surrounding the federal debt and deficits. Politicians and pundits compete in their proclamations of future disaster and the attribution of its causes.

The real story is that federal budget deficits *can* have great consequences for the economy. These may be good, as well as bad, but we cannot begin to know the consequences of deficits until we measure them correctly. When we do, we find that they can still be too large, but they can also be too small.

The underlying significance of government budget deficits is that they add to public debt, and hence to private holdings of that debt. Paradoxically, the federal debt, however frequently viewed as a burden to the government or the future taxpayers, is wealth to those who own it. Whatever their concerns for the government's fiscal responsibility, the holders of all those deficit-financing Treasury notes, bills and bonds feel richer for having them. And the richer they feel, the more they try to spend now and plan to spend in the future.

Since federal deficits add to federal debt, which thus adds to private wealth, they can be expected to increase aggregate demand, or spending. If

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*William R. Kenan Professor of Economics, Northwestern University. This paper has drawn very considerably from my forthcoming book, *How Real is the Federal Deficit?* (New York: The Free Press, May 1986). Earlier sources include my joint articles with Paul J. Pieper in *The American Economic Review* (March 1984) and *The Public Interest* (Winter 1985), and my own paper in *The American Economic Review* (May 1984).

the economy is booming along at full employment of its resources, further increases in demand raise prices and encourage inflation. But if there is slack in the economy, deficit-induced demand stimulates output and employment. The method of financing deficits, whether by interest-bearing debt or the creation of money, which is properly viewed as non-interest bearing debt, will also affect the levels of demand and spending and their allocation to consumption and domestic and foreign investment. It is these issues of the impact of deficits on the economy and not misguided moral imperatives which are properly central to our concerns.

But for deficits to matter, they must be real deficits. A real deficit is one which increases the real debt of the government to the public and hence increases the public's perception of its own real wealth. It is thus vitally important to correct for inflation. Inflation in effect generates an "inflation tax," eating away the value of the public's holdings of those Treasury notes, bills and bonds, or the cash which they back.

Our failure to adjust measures of the deficit for inflation has yielded a number of anomalies which have confused analysis and bedevilled policy-making. For with all our deficits, the general trend of real federal debt -- the debt adjusted for inflation — has been downward. On a per capita basis it has indeed gone down very sharply over most of the last forty years, until 1980. And the government's net worth, the difference between its assets — financial and real — and its liabilities, moved from red to black. The Employment Act of 1946, which established the Joint Economic Committee along with the Council of Economic Advisers, wisely committed the government to policies aimed at maximizing employment and purchasing power. Fiscal policy, particularly decisions as to total spending and taxes and consequent surpluses or deficits, have been properly recognized as essential in implementing this commitment. .

For a good deal of our post-World War II history, fiscal policy has been helpful. It has laid a framework for relatively high-employment and substantial prosperity and economic growth. There have also, however, been substantial failures, particularly in the 1970's and early 1980's. The coexistence of apparently large and increasing budget deficits, inflation, and growing unemployment seemed to some to indicate a breakdown in the framework for fiscal policy which had guided the United States and much of the world since the catastrophe of the Great Depression of the 1930's. In fact, what was at fault was not our view of basic economic relationships. It was rather mismeasurement of critical variables. Very simply, we had confused real and nominal values.

From the standpoint of macroeconomic policy, a real federal deficit is one which adds to the real value of federal debt held by the public. This is not the same as the nominal deficit because changing interest rates in themselves change the market value of existing debt, and inflation, which affects interest rates, also serves to reduce the real value of that market value of debt. Further, to the extent that the Treasury runs a deficit and borrows in order to finance lending to farmers, homeowners, businesses or students, the gross debt will rise more than the net debt of government. Thus, in Table 1, we note that, despite repeated budget deficits, the real value of federal debt declined sharply from 1945 to 1980. Indeed, the net debt per capita in 1972 dollars fell by almost three-quarters, from $4,017 at the end of 1945 to $1,032 at the end of 1980. It then more than doubled, from $1,032 to $2,183 by the end of 1984. At that time, however, the net debt per capita was still little more than than half of what it had been at the end of 1945.

Table 1 The Real Value of Federal Debt, 1945 TO 1984

(1) Year	(2) Gross Public Debt	(3) Net Debt	(4) Budget Surplus or Deficit (-)	(5) Net Reval. of Net Debt	(6) Change in Net Debt	(7) Net Debt per Capita	(8) Change in Net Debt per Capita
	Billions of 1972 Dollars					1972 Dollars	
1945	681.6	562.0	-111.0			4,017	
1950	459.1	351.0	17.2	-32.0	-44.0	2,305	-343
1955	455.4	323.0	7.3	-16.0	-21.3	1,947	-165
1960	421.1	300.5	4.4	11.0	8.5	1,663	21
1965	426.0	289.0	.7	-11.9	-10.4	1,487	-73
1970	415.3	268.4	-13.6	1.9	15.4	1,309	61
1975	445.9	277.0	-55.2	-16.0	57.3	1,283	255
1980	495.9	234.9	-34.3	-36.7	-1.0	1,032	-17
1984	730.7	516.7	-78.6	-9.5	86.7	2,183	350

Full accounts of sources and methods of this and subsequent tables are to be found in Eisner, How Real Is the Federal Deficit?

The major discrepancies between budget deficits and increases in net debt suggest that our conventional measures of the budget deficit are devoid of much of their presumed economic relevance. They are particularly misleading in periods of substantial and varying inflation and high and fluctuating nominal interest rates. For these contribute to large net revaluations of existing debt which are a major factor, generally the major factor, in the discrepancy between conventional measures of nominal budget deficits and increases in net debt. The exact relation between changes in the real value of the net debt, measured in current dollars, and the budget surplus or deficit may seen in Table 2. First, a surplus itself reduces the debt and a deficit increases it. Higher interest rates, however, also lower the market value of debt, and increases in prices reduce its real value. In addition, off-budget outlays increase the debt while increases in the market value of Treasury holdings of gold reduce the real net debt.

The decrease (increase) in real net debt in current dollars is actually the sum of the surplus (deficit) in our national income accounts, interest rate effects (par-to-market adjustment), price effects (nominal-to-real adjustment), off-budget items, and net revaluations on Treasury gold. To secure a measure of the impact of the surplus or deficit on the financial wealth of the individuals and business of the private sector or, more properly, all sectors other than the federal government, we should add to the surplus in national income accounts only the interest rate effects and the price effects. And since this measures changes in the financial wealth of the economy outside of Washington, it is this "adjusted surplus" or "adjusted deficit" which, as we shall show, will weigh heavily on the ebb and flow of the nation's economy.

Table 2 Federal Budget Surplus or Deficit and Change in Real Net Debt, Billions of Dollars

(1) Year	(2) Surplus or Deficit (-) on National Income Accounts	(3) Interest Rate Effects	(4) Price Effects	(5) Adjusted Surplus or Deficit (-)	(6) Off Budget Items	(7) Revaluation on Gold	(8) Decrease (+) or Increase (-) in Real Net Debt in Current $
1946	3.5	0.4	52.5	56.4	-2.1	-3.7	50.7
1950	9.2	2.9	15.0	27.1	-0.2	-3.3	23.6
1955	4.4	3.8	6.0	14.3	-0.7	-0.6	13.0
1960	3.0	-9.8	2.3	-4.5	-1.1	-0.2	-5.8
1965	0.5	3.1	5.9	9.5	1.9	-3.7	7.8
1966	-1.8	-1.7	8.1	4.6	-1.4	-0.5	2.7
1967	-13.2	4.4	8.0	-0.8	-0.2	-0.4	-1.4
1968	-6.0	1.1	11.5	6.5	-3.5	1.9	4.8
1969	8.4	7.5	13.4	29.4	-1.9	-2.9	24.6
1970	-12.4	-14.0	12.2	-14.2	-0.0	0.1	-14.1
1971	-22.0	-3.9	12.5	-13.4	-1.5	1.3	-13.6
1972	-16.8	4.3	12.4	-0.1	-1.3	5.4	4.0
1973	-5.5	3.4	21.3	19.1	-1.5	11.3	29.0
1974	-11.5	-2.0	31.2	17.7	0.0	18.4	36.1
1975	-69.3	-2.5	23.2	-48.6	-5.4	-18.0	-71.9
1976	-53.1	-12.6	21.1	-44.6	-5.1	-3.4	-53.0
1977	-45.9	16.1	29.2	-0.6	-8.6	5.8	-3.3
1978	-29.5	19.1	43.2	32.9	-8.7	12.3	36.5
1979	-16.1	4.6	43.6	32.1	-4.7	69.4	96.8
1980	-61.2	13.7	55.1	7.6	-12.1	6.3	1.8
1981	-64.3	-3.7	49.7	-18.3	-13.1	-47.8	-79.2
1982	-148.2	-62.4	33.4	-117.2	-6.8	-18.2	-202.3
1983	-178.6	42.3	35.1	-101.2	-13.3	-7.9	-122.4
1984	-175.7	-20.6	42.1	-154.1	-16.5	-23.1	-193.7

Since in the last four decades there has always been some inflation, which reduced the real value of the debt, the adjustments have generally moved the budget toward surplus. Thus, surpluses in the official national income accounts in the early post-war years were larger by our adjusted measure. Where there were deficits they were usually lower in the adjusted measure, or they became surpluses.

Some particularly interesting reversals are recorded. In 1973 and 1974 there were moderate deficits by the official national income account measure. With inflation accelerating in response to oil price shocks, our adjusted budget was in substantial surplus.

But the most remarkable differences between official and adjusted budget measures show up in the 1977-80 Carter years. The 1977 deficit of $46 billion is turned into a virtually balanced budget. The 1978 deficit of $29 billion is converted to an adjusted surplus of $33 billion. The 1979 deficit of $16 billion becomes an adjusted surplus of $32 billion. And the deficit of $61 billion which caused so much consternation in 1980 appears now as an adjusted surplus of $7.6 billion.

What then was really going on? Mesmerized by those official deficit figures, most observers insisted that our fiscal policy was irresponsibly expansionary. That justified Federal Reserve Chairman Paul Volcker's tight money policy as "the only game in town" to stop inflation.

But the rising interest rates associated with escalating inflation, reinforced by the restrictive monetary posture, had been driving down the market value of the public's holdings of federal debt. And the inflation itself was further reducing its real value. The purchasing power of the public was thus shrinking, not growing.

An inflation-adjusted budget would have told us that we were actually running a surplus. We were suffering from a tight fiscal policy and tight money. But everyone looked at the official deficit. The tricks played by inflation were ignored, or never seen.

Public concern and confusion regarding federal deficits and their contribution to federal debt are fueled by curious federal accounting practices. If major corporations kept their accounts in the same manner as the federal government, the demand for physical red ink would grow substantially. Many a profitable business would seem to be operating at a loss and, in government parlance, would be showing a "deficit." This would show that, like the federal government, American businesses have been going more and more into debt.

Can we compare the federal debt with that of private business? Take a look at Table 3. The gross debt or liabilities of General Motors grew from $4.3 billion to $27.9 billion from 1970 to 1984. The debt of IBM grew from $2.6 billion in 1970 to $16.3 billion in 1984. Similar records of increasing debt can be found for almost every successful large business in the United States.

In fact, business debt has been increasing much more rapidly than federal debt. At the end of 1952, gross federal debt held by the public was 62 percent of GNP, while the debt of nonfinancial business came to 32 percent, as shown in Table 4. By 1979, the federal debt ratio had fallen by more than half, to 26 percent, but the business debt figure had risen to double that, or 52 percent. By 1984 the federal debt held by the public had risen to almost 37 percent, but business debt was then 55 percent of GNP.

Table 3 Assets, Liabilities and Net Worth, General Motors and IBM, 1970, 1980, and 1984

(1)	(2)	(3)	(4)	(5)
Item	1970	1980	1984	1970 to 1984
	(Billions of Dollars)			(Percent Change)
General Motors				
Assets	14.2	32.2	52.1	+268
Liabilities	4.3	13.0	27.9	+546
Net Worth	9.9	19.2	24.2	+146
IBM				
Assets	8.5	24.5	42.8	+401
Liabilities	2.6	9.6	16.3	+530
Net Worth	5.9	15.0	26.5	+345

Data for 1984 are from annual reports. "Net worth" figures are what GM denotes as "net assets," and IBM as "stockholders' equity." IBM figures for 1980 have now been reclassified to conform with 1984 presentation. They show 1980 assets at $26.8 billion and stockholders' equity at $16.6 billion.

Table 4 Federal and Other Debt as Percent of GNP

(1) Year	(2) Federal	(3) State and Local	(4) Households	(5) Nonfinancial Business	(6) Total
1952	61.5	8.7	26.0	31.6	127.8
1962	43.6	14.5	44.7	40.5	143.4
1972	27.6	14.7	47.9	50.1	140.3
1973	25.4	14.1	48.7	51.3	139.4
1974	24.5	14.2	49.1	54.3	142.1
1975	27.5	13.7	47.9	52.0	141.1
1976	29.1	13.4	48.9	51.5	142.9
1977	28.8	12.7	50.5	51.5	143.5
1978	27.4	12.0	51.4	50.3	141.0
1979	26.5	11.7	53.9	51.9	144.0
1980	27.1	11.5	53.7	52.0	144.3
1981	27.4	10.7	52.6	52.0	142.6
1982	31.9	11.6	53.8	54.2	151.5
1983	34.3	10.8	55.0	53.0	153.1
1984	36.6	10.8	56.4	55.1	159.0

Source: Flow of Funds Accounts, Summary of Credit Market Debt Outstanding and Credit Market Debt Owed by Nonfinancial Sectors, Board of Governors of the Federal Reserve System. Years through 1982 taken from Albert M. Wojnilower, "Discussion," Table 1, p. 105, in Federal Reserve Bank of Boston (1983).

But investors or others trying to evaluate the fortunes of a corporation hardly look only at gross debt figures. Clearly, they must also concern themselves with assets.

Thus for example, while General Motors' liabilities grew, so did its assets and net worth. From 1970 to 1984, assets increased from $14.2 billion to $52.1 billion, and net worth, the difference between assets and liabilities, rose from $9.9 billion to $24.2 billion. In the case of IBM, from 1970 to 1984, assets increased from $8.5 billion to $42.8 billion, while net worth rose from $5.7 billion to $26.5 billion.

But then, with all the talk about government debt, and the deficits which contribute to it, what about looking also at *government* assets and *government* net worth? We are accustomed to thinking of the government taking our money and squandering it. There may of course be some truth to that. But after all, the government does own some roads and some buildings. It has some equipment, non-military as well as military. And it retains title to a great deal of land.

Thanks to my collaboration with Paul Pieper, I am able to present government balance sheets which show the market values (or estimated replacement costs) of all tangible and financial assets as well as liabilities. They indicate that the federal debt has indeed grown, like that of General Motors and IBM, but so have federal assets. The increase in financial assets, as noted earlier, damps the growth in net debt.

It is the growth in value of federal tangible assets, however, which deserves particular attention. In the decade of the 1970's, the value of federally owned structures, on the basis of BEA figures, increased from $106 billion to $284 billion, as may be noted in Table 5. Some outside estimates put the numbers considerably higher. The value of federal-owned equipment

Table 5. Federal Government Net Debt and Net Worth, Billions of Dollars

Assets	1945	1950	1960	1970	1980	1984
Tangible	186.2	111.7	205.8	304.6	822.5	1,118.0
Reproducible assets	179.3	102.2	187.4	259.8	648.1	915.2
Residential structures	2.2	2.2	3.2	5.7	20.9	24.5
Nonresidential structures	28.9	39.1	60.8	100.2	262.9	299.6
Equipment	88.3	34.4	65.6	95.3	228.6	395.6
Inventories	59.9	26.5	57.7	58.6	135.7	195.5
Land	6.8	9.5	18.4	44.8	174.4	202.8
Financial	102.8	98.7	124.7	232.8	720.9	887.4
Currency, demand + time deposits	31.3	9.7	12.8	17.6	31.3	40.7
Gold	20.1	22.8	17.8	12.0	155.9	81.0
U.S. government securities	31.5	26.2	35.2	77.5	129.8	172.3
Treasury issues	31.5	26.2	35.1	77.4	120.6	162.7
Agency issues	.0	.0	.0	.2	9.2	9.6
Mortgages	2.5	2.8	11.2	32.6	132.3	202.6
Other loans	4.7	16.0	25.1	65.2	201.5	288.1
Taxes receivable	9.6	16.5	12.7	5.7	7.1	-16.2
Miscellaneous assets	3.1	3.2	8.4	18.9	47.3	94.9
Total Assets	289.0	210.4	330.4	537.4	1,543.4	2,005.4
Liabilities						
Treasury currency + SDR certificates	2.3	2.4	2.7	6.0	13.6	17.5
Demand deposits + currency	31.1	28.2	30.6	52.0	121.5	171.4
Bank reserves + vault cash	19.0	19.9	20.4	31.2	47.3	40.5
Credit market instruments	264.5	224.5	246.7	338.5	841.9	1,613.7
Saving bonds	43.2	49.5	46.5	53.1	68.4	76.1
Other Treasury issues	220.4	173.1	192.5	246.1	625.1	1,296.8
Agency issues	.9	1.8	7.8	39.3	148.4	240.8
Insurance, retirement reserves	6.5	12.7	20.5	34.9	85.5	139.8
Miscellaneous liabilities	9.2	7.4	10.9	21.8	51.8	80.4
Total Liabilities	332.6	295.0	331.8	484.3	1,161.6	2,063.3
Net Debt[a]	229.8	196.3	207.1	251.5	440.7	1,175.9
Net Worth	-43.7	-84.6	-1.3	53.1	381.8	-57.9

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[a] Total liabilities minus financial assets.

rose from $95 billion to $229 billion. Inventories went from $59 billion to $136 billion. And the almost certainly underestimates of the value of federal land increased from $45 billion to $175 billion.

Dramatic evidence of the extent of these underestimates may be seen in Department of the Interior figures on federally owned reserves of oil, gas and coal. Multiplying the estimated quantities of these reserves by current market prices, we estimate the value of the government oil reserves at $177 billion, gas at $169 billion, and coal at $264 billion. That gives a total of $611 billion in federally owned, off-shore and on-shore minerals to be added to our estimates of the value of "land," or separately categorized among assets. There alone is "backing" for more than half of the net debt. And Michael Boskin and associates offer still higher estimates of the value of Federal minerals, setting the 1982 value of oil and natural gas rights alone at $817 billion (Boskin, Robinson, O'Reilly, and Kumar, The American Economic Review, December 1985.)

Thus, from 1970 to 1980, total liabilities grew what seems an enormous amount, from $484 billion to $1,162 billion, and net debt from $252 billion to $441 billion. But that is only part of the picture. With tangible and financial federal assets each rising by half a trillion dollars, the growth in total assets considerably exceeded the growth in liabilities.

So, yes, the federal debt did grow as deficit followed deficit. But there was something to show for it. And with all that increase in debt, as with General Motors and IBM, the federal net worth also increased. It rose, according to our conservative estimates, from a modest $53 billion in 1970 to a 1980 figure of $382 billion, and clearly would be shown to have risen much more with proper accounting for federally owned mineral reserves.

Despite this substantial increase in federal net worth in the 1970's (not repeated in the following decade, it must be acknowledged), we kept referring to federal deficits. When private businesses had similar increases in debt, assets and net worth we did not think of them as suffering losses or having "deficits." What is the difference?

A significant part of the answer lies in the fact that the federal government, unlike private business and state and local governments, keeps no separate capital budget. When American businesses spend $354 billon on new plant and equipment, as they did in 1984, they do not charge that as a current expense. Profits, or "surplus" are reduced only by depreciation or "capital consumption." But when the federal government makes similar capital expenditures of $77 billion, as it did in (fiscal year) 1984, that goes right into the deficit.

In the great majority of firms where capital expenditures are increasing, whether because of real growth or inflation or both, the current depreciation, which is based essentially on previous capital expenditures, is less than current capital spending. For General Motors in 1984, depreciation on old plant and equipment was $2.7 billion while new capital spending was $6.0 billion. For IBM, depreciation was $3.0 billion and capital spending $4.6 billion. Since federal capital expenditures have been increasing too, federal depreciation charges similarly calculated would also be less than federal spending.

If the federal government were to keep separate current and capital accounts as does private business, and were also to adjust its depreciation for inflation, the budget picture would look considerably different. In 1984, for example, as shown in Table 6, the total national income account federal sector budget deficit of $176 billion would be decomposed into a capital

Table 6 Current and Capital Federal Accounts, 1984

(1) Account	(2) Credits	(3) Debits	(4) Deficit[a]	(5) Deficit ÷ GNP
	Billions of Dollars			Percent
Current	704.7	860.9[b]	156.2	4.3
Capital	53.6[c]	73.2[d]	19.6	0.5
NIPA	704.7	880.5	175.8	4.8

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[a] Col. 4 is Col. 3 minus Col. 2

[b] Includes capital consumption allowances of $53.6 billion and current outlays of $807.3 billion.

[c] Capital consumption allowances.

[d] Capital expenditures.

account deficit of $20 billion and a current account deficit of $156 billion. The difference, though significant, is not overwhelming. But there is more to be said.

First, the $20 billion deficit on capital account in 1984 and the total of $73 billion of federal investment related only to assets acquired by the federal government. But in fiscal 1984, for example, that would omit another $26 billion of federal grants to state and local governments for physical capital investment -- for highways, for urban mass transportation and airports, for community and regional development and for pollution control facilities.

Second as the Office of Management and Budget points out, a reasonable definition of the category of federal investment is outlays "which yield long-term benefits." The OMB therefore includes among "federal investment-type outlays" $41 billion for research and development and $22 billion for education and training. Total federal investment, excluding loans and financial investment, thus came to $171 billion in fiscal 1984, almost identical, we might point out, to the national income account deficit of $170 billion. The OMB's estimates of non-financial federal investment for 1985 and 1986 are $195 billion and $215 billion, respectively.

It is thus clear that all of the federal budget deficit, and more, is accounted for by investment. We should, it is true, make some allowance for depreciation or capital consumption. Thus, if we were to put together separate current and capital accounts, with all federal investment-type outlays in the capital account but depreciation as an added current account charge, the current account budget would still not be in balance.

But the figures for the current account deficit would be far less than those to which we have become familiar. When we add the inflation adjustments discussed earlier and relate all this to the growth of population and the economy, we may easily have no deficit left at all.

* * * * *

The federal budget, by official measure, has been in deficit in all but eight of the fifty-five years from 1931 through 1985. In fact, in the twenty-five years since 1960 only one, 1969 had no deficit. The last sixteen years have presented an unbroken picture of deficits.

World War II saw what were then huge deficits, totaling $170 billion for the years 1942 through 1945. The total gross federal debt over that period rose by $203 billion.

From 1946 through 1984, budget deficits, net of surpluses, totaled $988 billion and, including off-budget outlays, totaled $1,112 billion. And over that period, the gross federal public debt increased by $1,317 billion. This is a history, which in at least general terms, is well etched in the public consciousness. It has been the stuff of many sober pronouncements and warnings and has frequently agitated political debate. A number of additional items of information, however, complicate the picture, and also put it in better perspective.

First, when numbers are changing rapidly over time, particularly with economic growth and inflation, it is important to put the figures in some kind of relative terms. The gross federal debt held by the public, for example, grew from $235 billion at the end of the 1945 fiscal year to $1,313 billion by the end of the 1984 fiscal year. But our national income and gross national product grew relatively more over these years. Thus, as may be seen in Table 7, while the gross federal debt held by the public was 108.4 percent of gross

Table 7 Federal Budget Surpluses and Deficits and Gross Federal Debt, Selected Fiscal Years, 1941 to 1984

(1) Fiscal Year	(2) Surplus or Deficit (-) On Budget (Billions of Dollars)	(3) Surplus or Deficit (-) Including Off-Budget Outlays (Billions of Dollars)	(4) Gross Federal Debt (End of Period) Total (Billions of Dollars)	(5) Gross Federal Debt (End of Period) Held by the Public (Billions of Dollars)	(6) Gross Federal Debt (End of Period) Held by the Public (% of GNP)
1941	-5.0	-5.0	57.5	48.2	44.2
1945	-47.5	-47.5	260.1	235.2	108.4
1946	-15.9	-15.9	271.0	241.9	119.8
1960	0.3	0.3	290.0	237.2	47.6
1970	-2.8	-2.8	382.6	284.9	29.4
1975	-45.2	-53.2	544.1	396.9	26.8
1980	-59.6	-73.8	914.3	715.1	27.8
1984	175.3	-185.3	1,576.7	1,312.6	36.7
Sum, 1942-45 or Change 1941-45	-170.1	-170.1	202.6	187.0	64.2
Sum, 1946-84 or Change 1945-84	-987.6	-1,112.6	1,316.6	1,077.4	-71.7
Sum, 1946-80 or Change 1945-80	-448.4	-512.3	654.2	479.9	-80.6
Sum, 1981-84 or Change 1980-84	-539.2	-599.9	662.4	597.5	8.9

national product at the end of fiscal 1945, despite the very large dollar growth in that debt over the following years, it had fallen, as a percentage of gross national product, to 27.8 percent by the end of the 1980 fiscal year. With all the subsequent red ink and increase in the debt, at the end of the 1984 fiscal year the debt as a ratio of GNP had risen to only 36.7 percent, still well below the 108.4 percent figure of 1945 (and the 119.8 percent figure of 1946).

There are some analogous observations to make with regard to our annual budget deficits. They surged during the years of World War II, but then were generally modest until they rose toward the end of the Vietnam War, and surged again after 1981. Over all these years federal outlays and receipts have been fluctuating -- generally growing -- and gross national product has increased enormously. How can we get an appropriate view of the relative size of the deficit?

One way of securing a broader perspective is to note what has happened to the deficit as a percentage of outlays. We see in Table 8 that, while the proportion of federal outlays which is deficit-financed stood at a substantial 21.8 percent in fiscal 1984, this was far from a record. During the depression fiscal year of 1932 (from July 1, 1931 through June 30, 1932), although the deficit was "only" $2.7 billion, 58.7 percent of federal outlays were deficit-financed. And during the war years, that proportion soared, rising to 70 percent in 1943. In the presumably fiscally responsible Administration of Dwight Eisenhower, in fiscal 1959, the ratio rose to 13.96 percent. During the peak-deficit, Vietnam fiscal year of 1968, the ratio was slightly higher, some 14.3 percent.

Table 8 Federal Receipts and Outlays, and Surplus or Deficit as Percent of Outlays and GNP Fiscal Years, 1929-1984

(1) Fiscal Year	(2) Receipts Billions of Dollars	(3) Outlays (Including Off-Budget Outlays) Billions of Dollars	(4) Outlays (Including Off-Budget Outlays) As Percent of GNP	(5) Surplus or Deficit (-) Billions of Dollars	(6) Surplus or Deficit (-) As Percent of Outlays	(7) Surplus or Deficit (-) As Percent of GNP
1929	3.9	3.1	3.03	0.7	23.47	0.71
1932	1.9	4.7	6.96	-2.7	-58.70	-4.09
1943	23.6	78.5	44.37	-54.9	-69.89	-31.01
1945	45.2	92.7	42.71	-47.5	-51.22	-21.88
1946	39.3	55.2	27.32	-15.9	-28.73	-7.85
1959	79.2	92.1	19.41	-12.9	-13.96	-2.71
1960	92.5	92.2	18.52	0.3	0.29	0.05
1965	116.8	118.2	17.93	-1.6	-1.35	-0.24
1966	130.8	134.5	18.57	-3.8	-2.82	-0.52
1967	148.3	157.5	20.26	-8.7	-5.53	-1.12
1968	153.0	178.1	21.42	-25.2	-14.13	-3.03
1969	186.9	183.6	20.16	3.2	1.76	0.36
1970	192.8	195.6	20.19	-2.8	1.45	-0.29
1971	187.1	210.2	20.38	-23.0	-10.96	-2.23
1972	207.3	230.7	20.44	-23.4	-10.13	-2.07
1973	230.8	245.7	19.62	-14.9	-6.06	-1.19
1974	263.2	269.4	19.53	-6.1	-2.26	-0.44
1975	279.1	332.3	22.45	-53.2	-16.01	-3.59
1976	298.1	371.8	22.57	-73.7	-19.82	-4.49
1976TQ	81.2	96.0	22.21	-14.7	-15.31	-3.40
1977	355.6	409.2	21.97	-53.6	-13.10	-2.88
1978	399.7	458.7	21.93	-59.0	-12.86	-2.82
1979	463.3	503.5	21.36	-40.2	-7.98	-1.71
1980	517.1	590.9	22.94	-73.8	-12.49	-2.87
1981	599.3	678.2	23.50	-78.9	-11.63	-2.73
1982	617.8	745.7	24.48	-127.9	-17.15	-4.20
1983	600.6	808.3	25.09	-207.8	-25.71	-6.45
1984	666.5	851.8	23.79	-185.3	-21.75	-5.17

Fiscal years until 1976 ran from July 1 of the preceding calendar year to June 30. From 1977 on, the fiscal years began on October 1. TQ denotes the transition quarter, July 1 to September 30, 1976.

The size of the deficit relative to the economy as a whole may be reasonably captured by the ratio of the deficit to gross national product. That ratio was also relatively high in depression and war years but fairly small over the rest of the period until the years from 1982 on.

But how can we measure the effects of deficits on the economy? Do they cause inflation or recession? Do they reduce unemployment or crowd out investment? Do they stifle economic growth or stimulate it? Do they increase our foreign debt and wreck our balance of trade, or do they contribute to world prosperity?

A simple, naive approach would be to relate the federal deficit to some of the broad aggregates in which we are interested. We might check the correlations among deficits and gross national product, business investment, or the rates of unemployment or inflation. The difficulty, a common one in economics, is especially serious here: we cannot distinguish between cause and effect.

The problem is that the economy affects the deficit, perhaps as much as or more than the deficit can be expected to affect the economy. When economic conditions are good, incomes, profits and employment are high. Treasury receipts, tied as they are to individual and business income taxes and payroll taxes on employment, are hence high. Further, government expenditures for unemployment benefits and welfare payments will be less when the economy is prosperous.

The combination of higher tax receipts and lower expenditures means a lower deficit. But it is clearly the high GNP, income, profits and employment that have caused the low deficit, and not the reverse. Since high rates of saving and investment generally accompany high GNP, income and profits, they too would be associated with smaller deficits. The inference that the smaller deficits brought on the higher saving and investment would be similarly unwarranted.

The inverse relation between deficits and inflation is somewhat more complex. At first blush it might appear that inflation would be neutral in its effects on the deficit. While higher prices would mean larger nominal incomes and hence greater tax payments to the Treasury, the government would also have to pay more for what it buys. If federal salaries and social security benefits are indexed to the cost of living, we might conclude that expenditures and receipts would both be increased by inflation and the deficit therefore not changed.

There are, however, a number of complications. First, income taxes have historically risen more than in proportion to the increases in income brought on by inflation. This has happened because of the notorious "bracket creep" -- inflation has pushed more of income into taxable brackets and into higher brackets with higher tax rates.

While indexing of exemptions and tax brackets to the price level has now essentially ended that contribution of inflation to a more than proportional enhancing of individual income tax payments, the effect of inflation in bringing more than proportional increases in business tax payments remains. This stems from the failure of original cost depreciation deductions to rise with inflation, as well as swollen inventory profits of firms which use FIFO ("first-in, first-out") accounting. For revenues reflect current higher prices while accounting costs of materials and fixed capital are based on the lower prices of bygone days.

Inflation also brings about more than proportionate increases on the expenditure side. These stem from the higher interest rates and hence greater Treasury interest payments as inflation expectations take hold.

In the past, bracket-creep effects of higher prices were such that inflation tended on balance to reduce deficits. But such an association of higher inflation with lower deficits can *not* then warrant the inference of the inverse relation -- that *deficits* reduce *inflation*.

Actual budget deficits are therefore not a good measure of fiscal policy. The Administration and the Congress might be following a tight fiscal policy, keeping discretionary expenditures down and tax rates up, and yet a recession would create a substantial deficit. Indeed the tight fiscal policy, by depressing aggregate demand, might bring on such a recession.

To ascertain what deficits do to the economy, we need a measure that is uncontaminated by what the economy does to deficits. Economists have been able to develop a measure that removes some of the contamination, that brought on by cyclical fluctuations in income and employment. It has been variously called the full employment, high-employment, and standardized employment budget, and the cyclically-adjusted budget and the structural budget.

Whatever its name, the important thing about this budget is that it presents estimates of what expenditures and receipts, and hence the deficit, *would be* if the economy were at a level of activity independent of cyclical variations in employment, output and income. Since the cyclical variations in output and income are closely associated with those of employment and unemployment, the budget has usually been defined for a constant rate of unemployment.

The Bureau of Economic Analysis of the Department of Commerce has in fact constructed a series of high-employment budget surpluses and deficits beginning in 1955. "High" employment was initially taken to mean four percent unemployment, but that figure was raised in several steps in later years, apparently on the assumption that structural or demographic change in the economy was increasing the amount of unemployment -- unfortunately frequently called the "natural" rate of unemployment — which should be accepted as consistent with high employment. It was argued, particularly, that the population contained increasing proportions of youths and urban Blacks, with high rates of even noncyclical unemployment, and these increasing proportions were forcing up the national average of unemployment which was attainable.

The comparison of actual and high employment budgets is intriguing. From 1955 to 1965, as shown in Table 9, the actual budget was in deficit five times and in surplus six. The high-employment budget was never in deficit. When the actual budget was in surplus the high-employment budget was more so. All this reflected the fact that actual unemployment was more than the high-employment rate over this period. Hence actual tax revenues were less while government expenditures were more.

From 1966 to 1969, with the boon aggregate demand produced by the Vietnam War, actual unemployment was less than the four percent high-employment rate. (That is an interesting commentary on our view of "high-employment" even then. Quite ignoring the Humphrey-Hawkins Full Employment and Balanced Growth Act, we now cheerfully project unemployment in the six and seven percent range.) The low unemployment of those years caused the three actual deficits to be less than the high-employment deficit, and the 1969 surplus to be greater.

The 1970's ushered in the era of unrelenting federal deficits. For none of the last sixteen years has the budget been balanced, let alone in surplus. Those who saw deficits as evidence of undbridled government spending contributing to inflation seemed to have some support for their views. Inflation rose through most of the decade of the seventies, peaking in 1981. But then, as deficits soared to unprecedented heights in 1982, inflation rates dropped precipitously.

TABLE 9 ACTUAL AND HIGH-EMPLOYMENT FEDERAL BUDGET SURPLUSES AND DEFICITS ON NATIONAL INCOME ACCOUNT, 1955-84

(1)	(2)	(3)	(4)	(5)
YEAR	ACTUAL	HIGH-EMPLOYMENT	ACTUAL	HIGH-EMPLOYMENT
	(BILLION OF DOLLARS)		(PERCENT OF GNP)	
1955	4.4	5.2	1.10	1.30
1956	6.1	7.9	1.44	1.87
1957	2.3	6.1	.51	1.37
1958	-10.3	.0	-2.28	.00
1959	-1.1	5.4	-.23	1.11
1960	3.0	12.1	.60	2.39
1961	-3.9	7.1	-.74	1.35
1962	-4.2	3.0	-.75	.53
1963	.3	7.4	.04	1.24
1964	-3.3	1.1	-.51	.17
1965	.5	.9	.08	.13
1966	-1.8	-5.6	-.24	-.74
1967	-13.2	-15.1	-1.65	-1.89
1968	-6.0	-11.0	-.69	-1.26
1969	8.4	4.9	.89	.52
1970	-12.4	-4.6	-1.25	-.46
1971	-22.0	-11.3	-2.04	-1.05
1972	-16.8	-12.1	-1.42	-1.02
1973	-5.5	-9.5	-.42	-.72
1974	-11.5	-.3	-.80	-.02
1975	-69.3	-29.1	-4.47	-1.88
1976	-53.1	-17.4	-3.09	-1.01
1977	-45.9	-20.4	-2.39	-1.06
1978	-29.5	-15.9	-1.36	-.73
1979	-16.1	-2.0	-.67	-.08
1980	-61.2	-17.1	-2.33	-.65
1981	-64.3	-3.2	-2.17	-.11
1982	-148.2	-32.6	-4.83	-1.06
1983	-178.6	-59.7	-5.40	-1.81
1984	-175.8	-108.6	-4.80	-2.96

The deficits were widely interpreted, nevertheless, as evidence of expansionist fiscal policy. Richard Nixon had said in 1972, "We are all Keynesians now." If the Keynesian analysis which had presumably come to dominate policymaking were correct, should not unemployment have been low and the economy sizzling? In fact, unemployment was inching up and the economy was sluggish. What was wrong?

One try at an answer was that it was the actual budget that showed the repeated and generally growing deficits. As we have observed, these deficits may have been essentially the product of poor economic conditions, rather than their cause. We may point, for example, to the then record deficit of $69 billion in 1975. Clearly that was largely the result of the sharp 1974-75 recession. Unemployment after all averaged 8.5 percent in 1975. If we had looked at the high-employment budget might we have had a different picture?

But now comes the shocker. The high-employment budget deficit was less than the actual deficit throughout the 1970s and into the 1980s, but it too was never quite balanced, coming close only in 1974. Indeed, in 1975 the high-employment deficits seemed generally to be getting larger, not smaller.

It might be said that with growth in the economy and inflation everything was getting larger. The deficit figures would be more comparable over time if they were adjusted for this growth. A simple way to do this is to present the deficit figures as percentages of GNP. As we can also see in Table 9, however, this does not change the basic picture. Actual deficits as a percentage of GNP set post-World-War-II records. But high-employment budgets also showed an unmistakable trend to deficit.

Indeed, the high-employment budget was never in deficit and was usually substantially in surplus until the Vietnam War. By 1966, however, the high-employment budget moved to deficit and remained in deficit thereafter, with the solitary exception of the tax-surcharge year of 1969. It would thus appear that the original charge that fiscal policy had been overly expansive is supported — or at least not contradicted — by the history of the high-employmnet budget deficit.

* * * * *

We come now to our critical departure. We must adjust deficits for inflation. The real, actual surplus or deficit may be viewed as essentially the sum of three components: 1) the nominal surplus or deficit as currently measured; 2) an adjustment for changes in the market value of government financial assets and liabilities due to changes in interest raes; and 3) an adjustment for changes in real value due to changing general price levels incident to inflation. An identical or analogous set of adjustments is appropriate for the high-employment budget surplus or deficit.

We can then calculate the adjusted high-employment budgets which, by correcting for these inflation effects, come closer to measuring real surpluses or deficits and the consequent thrust of fiscal policy on aggregate demand. Applying our calculations of net revaluations on actual net federal debt, we originally adjusted the official high-employment budget surplus series for the years 1955 through 1981. Maintaining the 5.1 percent unemployment benchmark for high employment in effect in the official series since 1975, we have now extended our calculations to 1984.

The results, shown in Table 10, are dramatic. Inflation and rates of interest were low and relatively steady in the early 1960's prior to escalation of our military involvement in Vietnam. Corrections to the official high-employment budget surplus are hence generally small in those early years.

TABLE 10 HIGH-EMPLOYMENT SURPLUS AS PERCENT OF GNP, 1955-1984

(1)	(2)	(3)	(4)	(5)	(6)
	SURPLUS OR DEFICIT (-) ON NATIONAL INCOME ACCOUNTS				
YEAR	OFFICIAL	ADJUSTED FOR PRICE EFFECTS	ADJUSTED FOR INTEREST EFFECTS	ADJUSTED FOR PRICE AND INTEREST EFFECTS	PERCENT CHANGE IN GNP
		(PERCENT OF GNP)			
1955	1.30	2.81	2.26	3.77	6.72
1956	1.87	3.83	2.79	4.74	2.14
1957	1.37	2.46	.11	1.20	1.82
1958	.00	.93	1.32	2.24	-.42
1959	1.11	2.09	1.96	2.94	5.99
1960	2.39	2.83	.45	.89	2.15
1961	1.35	1.99	1.81	2.45	2.63
1962	.53	1.28	.12	[illegible]	5.78
1963	1.24	1.79	1.70	2.25	4.02
1964	.17	.78	.12	.72	5.27
1965	.13	.98	.58	1.43	6.04
1966	-.74	.33	-.97	.11	5.97
1967	-1.89	-.89	-1.33	-.34	2.70
1968	-1.26	.06	-1.14	.18	4.62
1969	.52	1.94	1.32	2.74	2.79
1970	-.46	.77	-1.87	-.64	-.18
1971	-1.05	.11	-1.41	-.25	3.39
1972	-1.02	.02	-.66	.39	5.66
1973	-.72	.89	-.46	1.14	5.77
1974	-.02	2.15	-.16	2.01	-.64
1975	-1.88	-.38	-2.04	-.54	-1.18
1976	-1.01	.22	-1.75	-.52	5.41
1977	-1.06	.46	-.23	1.30	5.51
1978	-.73	1.26	.15	2.15	5.03
1979	-.08	1.72	.11	1.91	2.84
1980	-.65	1.45	-.13	1.97	-.30
1981	-.11	1.57	-.23	1.45	2.52
1982	-1.06	.02	-3.10	-2.01	-2.13
1983	-1.81	-.75	-.53	.54	3.70
1984	-2.96	-1.81	-3.53	-2.37	6.78

But in later, more inflationary years, when the official high-employment budget as well as the actual budget moved substantially to deficit, the corrections are striking. In the 1970's, the entire perceived trend in the direction of fiscal ease or expansion is eliminated or reversed. The high-employment budget surplus, fully adjusted for price and interest effects, was higher as a percent of GNP for every year from 1977 through 1981 than the surplus of all but two of the years from 1966 through 1976. The only exceptions were the tax-surcharge year of 1969 and the oil-price-shock year of 1974. With similar exceptions, the surplus adjusted only for price (and not interest) effects was higher in every year from 1978 to 1981 than in any other year back to 1963. And since we have accepted Bureau of Economic Analysis increases in the "high-employment" bench mark from 4.0 percent to 5.1 percent unemployment over the period of its "official" series, we may well understate the move to fiscal tightness. The high-employment surpluses would have been even greater in later years if calculated at 4.0 percent unemployment.

So some significant rewriting of recent economic history is in order. Inflation could hardly be ascribed to excess demand associated with increasing fiscal ease and stimulus if, at least by the appropriately corrected high-employment budget measure, there was no such movement to fiscal ease. Some explanation of sluggishness in the economy, climaxed by the severe 1981-82 recession, might then be found in a relatively tight fiscal policy, as measured by the adjusted high-employment budget surplus, as well as in the widely blamed (or credited) role of monetary policy.

The record of deficits from 1982 on is another matter. We shall come to that later. For now we want to show the relation of budget deficits to the economy. And we will find that prevailing views reflect the distortions of improper measures, the most important of which, again, are those tricks played by the effects of inflation.

A few charts can begin to set the record straight, and tell a dramatic new story. First, Figure 1 shows the widening gap between official and price-adjusted high-employment budget surpluses or deficits as inflation began to heat up in the late 1960s. The two measures moved up and down in broadly similar fashion. But by the mid-1970s the inflation-adjusted budgets were some 1.5 to 2 percentage points more in surplus or less in deficit than the unadjusted, official high-employment budgets.

What about the relation between budget deficits and the economy? In Table II we relate annual changes in real gross national product for the years 1967 to 1984 to previous high-employment surpluses or deficits. GNP change is tabulated as greater or less than the median growth of 3 percent over this period.

In the upper left-hand panel we see again that the official high-employment budget was in deficit in seventeen years, in nine of which GNP growth was more than 3 percent and in eight of which it was less. For the one year of surplus (1969), subsequent growth was less than 3 percent (in fact, virtually zero), but one year does not offer very much evidence. In the lower left-hand panel, however, we observe that the adjusted budget was in surplus in twelve of the years. For the years that it was in surplus, subsequent GNP growth was more than 3 percent only three times, and less than 3 percent nine times. For all of the six years that it was in deficit, subsequent GNP growth was more than 3 percent.

Table 10 High Employment Surpluses and Deficits and Growth in GNP, 1967-1984

1. Official Budget

Previous High-Employment Budget	$\Delta GNP \gtrless 3\%$ Greater (+)	Less (-)	Total (T)
Surplus (+)	0	1	1
Deficit (-)	9	8	17
Total (T)	9	9	18

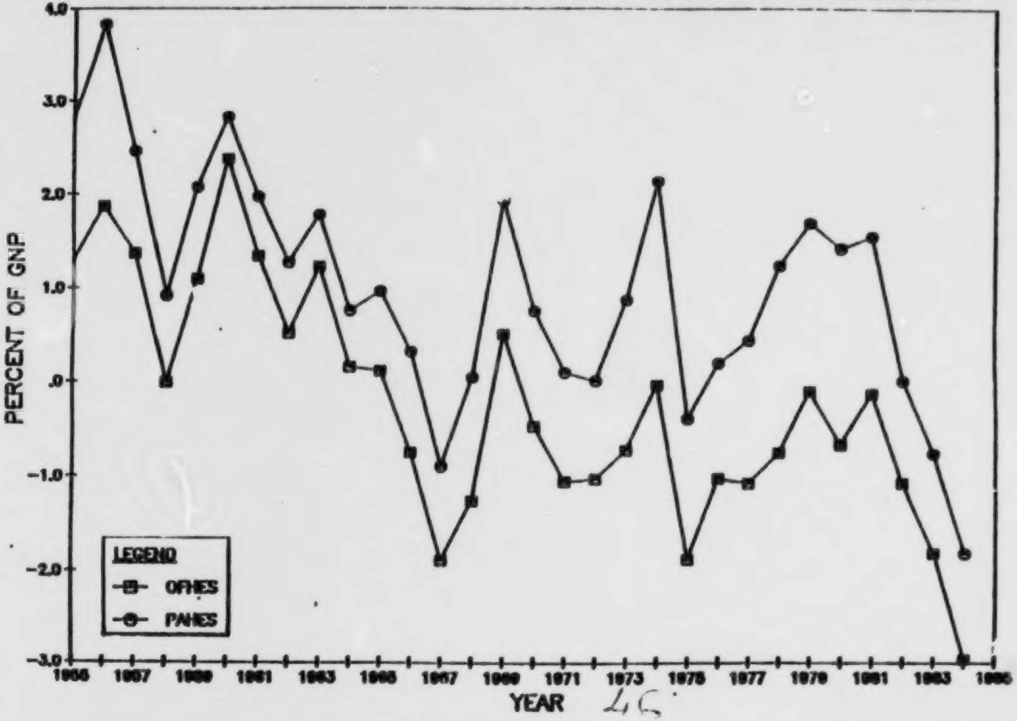
Previous High-Employment Budget	$\Delta GNP \gtrless 3\%$ Greater (+)	Less (-)	Total (T)
Deficit < 1%	1	8	9
Deficit > 1%	8	1	9
Total (T)	9	9	18

2. Price- and Interest-Adjusted Budget

Previous High-Employment Budget	$\Delta GNP \gtrless 3\%$ Greater (+)	Less (-)	Total (T)
Surplus (+)	3	9	12
Deficit (-)	6	0	6
Total (T)	9	9	18

Previous High-Employment Budget	$\Delta GNP \gtrless 3\%$ Greater (+)	Less (-)	Total (T)
Surplus > 1%	1	7	8
Surplus < 1% or deficit	8	2	10
Total (T)	9	9	18

FIGURE 1 OFFICIAL AND PRICE-ADJUSTED HIGH-EMPLOYMENT BUDGET SURPLUS



The official high-employment budget surplus or deficit is in fact also closely related to subsequent growth in GNP. This relation becomes clear when we recognize that inflation makes a true surplus appear as a deficit in the official accounts, and recategorize our official budgets accordingly. Thus, in the upper right-hand panel of Table 11, we divide the period into years when the previous official high-employment deficit was less than one percent of GNP and years when it was more than one percent. We find that for the nine years when the deficit was less than one percent, subsequent GNP growth was greater than 3 percent in only one case. For the nine years when the deficit was more than one percent, subsequent GNP growth was more than 3 percent in eight cases.

Recategorization of the price- and interest-adjusted high-employment budget as in surplus by more or less than one percent (or in deficit) shows similar results. For the eight years in which the surplus was more than one percent, subsequent GNP growth was greater than 3 percent in only one. For the ten years when the adjusted budget was in surplus by less than 1 percent or was in deficit, subsequent GNP growth was greater than 3 percent eight times.

But a single picture may be worth a thousand words, or as many statistics. Figure 2 juxtaposes the percentage change in real gross national product and the previous year's price-adjusted high-employment deficit as a percent of real gross national product.

The two curves, it must be conceded, show a remarkable fit. The greater the deficit, the greater the next year's increase in GNP. The less the deficit, the less the increase or the greater the decline in the next year's GNP.

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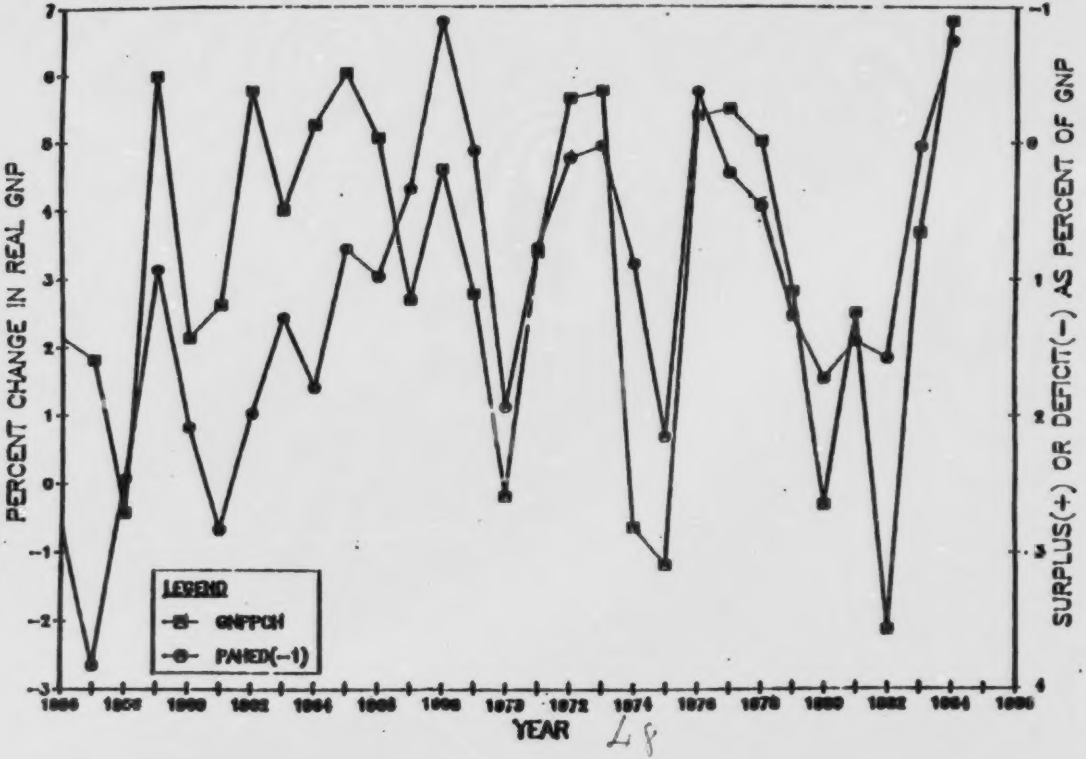
FIGURE 2 LAGGED PRICE--ADJ. HIGH--EMPLOYMENT DEFICIT AND CHANGE IN GNP



Changes in real GNP, as is well known, are closely but inversely related to changes in unemployment. Production requires labor and the more people that are working the greater is output. When unemployment goes up, real GNP growth slackens or actually becomes negative. When unemployment goes down, GNP goes up. And the faster unemployment goes down, the faster GNP rises.

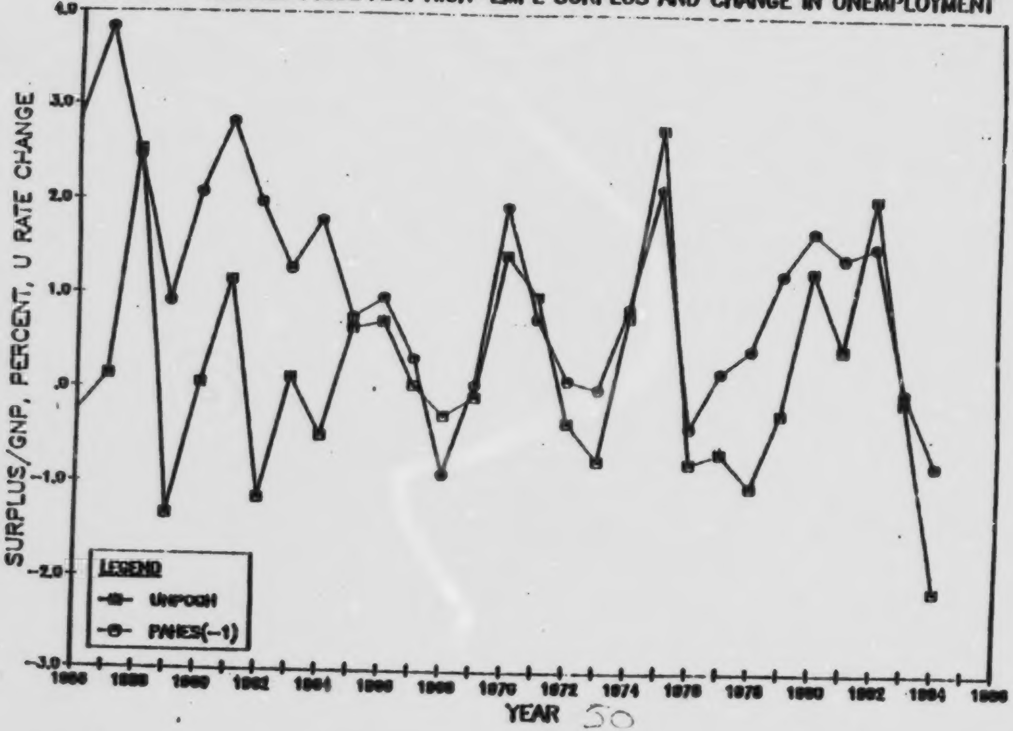
In view of the relation between the deficit and GNP, we should thus expect a similar close, but inverse, relation between the deficit and changes in unemployment. Figure 3 confirms this. Converting the inverse relation with the deficit into a direct one, it plots the percentage point change in unemployment and the previous year's ratio of the price-adjusted high-employment surplus (the negative of the deficit).

The close fit of the two curves is again outstanding. Higher surpluses -- or lesser deficits -- are associated with greater increases or lesser decreases in unemployment.

This relation indicating the stimulative effect of budget deficits has held up under a substantial amount of more vigorous statistical analysis, reported upon in my forthcoming book, How Real is the Federal Deficit? That analysis indicates that monetary policy, as measured by changes in the monetary base, also affects rates of growth of gross national product and unemployment. The independent effect of budget deficits remains substantial, however, probably greater, when the deficit is adjusted for inflation, than effects of changes in the monetary base.

Budget deficits are found to be positively associated not only with increases in consumption but also with increases in investment. Deficits in the past have generally "crowded in" investment, not crowded it out. There is evidence as well, however, that budget deficits have contributed to increasing our trade deficit, particularly in their association with

FIGURE 3 LAGGED PRICE ADJ. HIGH-EMPL SURPLUS AND CHANGE IN UNEMPLOYMENT



substantial increases in imports. It should be added that these increases in our imports have in turn stimulated growth in output in our OECD partners. And it may be added, finally, that after adjustment for inflation, it turns out that Japan had the greatest deficits in recent years along with the fastest growth. And the very slow-growing United Kingdom had substantial budget surpluses after inflation adjustment.

* * * * * *

Where does all this leave us? The officially reported federal debt has been growing at astronomical rates. Since President Reagan took office in 1981 the gross public debt has more than doubled, from $930 billion to $1.9 trillion. The increase has reflected huge and repeated annual deficits, reaching $212 billion in fiscal 1985.

But this has not been all bad! Indeed, given the economic collapse of 1981-82, lesser deficits would have made the deep recession worse. Unemployment would have risen above the official 10.7 percent figure, which was already the highest since the Great Depression of the 1930s. Total production and business profits would have been less. Without the huge deficits, we would not have had the brisk recovery of 1983 and 1984. And the 1984 election results -- whether regarded as good or bad -- might well have been quite different.

Up to about 1966, when inflation was relatively minor, budget deficits were really budget deficits. In the period from 1966 on, however, when inflation became substantial, the officially balanced budget turned into one of surplus after inflation corrections were made. A balanced, inflation-adjusted high-employment budget would have been substantially expansionary, producing high rates of growth of GNP and declines in unemployment. As late as 1981, however, we had a roughly balanced official high-employment budget, while the budget adjusted for inflation was substantially in surplus.

The Carter Administration, along with most outside critics, ignoring indications of sluggishness in the economy, interpreted the combination of apparent deficits and inflation as indicating excess demand. It initiated moves to combat the inflation by encouraging a tight money policy and, in its final years, striving to reduce budget deficits. This policy continued through the first year of the Reagan Administration as domestic spending was further restrained and more taxes rose than declined.

But in fact, fiscal policy was not stimulative. The high inflation and rising interest rates meant that budgets seemingly in deficit were actually in substantial surplus. Our statistical relations indicate strongly that these inflation-adjusted surpluses contributed significantly to the 1981-83 recession.

This suggests two important correctives to widespread views of fiscal and monetary policy. First, that recession cannot properly be interpreted as a triumph of all-powerful monetary constraints over relatively ineffective fiscal ease. Tight monetary policy and tight fiscal policy were its proximate causes.

Thus, those who acquiesced in tight money as "the only game in town" to slow a presumedly overheated, inflationary economy were wrong on two counts. First, the inflation had come from supply shocks, with critical energy prices up some 500 percent in a decade, rather than excess demand, an inference reinforced by the absence of real increases in fiscal thrust. And second, a strong-willed rejection of accommodative monetary policy, rather than balancing budget excesses, offered a near lethal combination of monetary and fiscal contraction.

But fiscal policy moved in a monumentally different direction in 1982. A combination of major tax cuts and increases in military expenditures with a fall in inflation and interest rates converted the adjusted high-employment budget from a very high surplus to a very high deficit. Indeed, the change of 3.46 percentage points, from a surplus of 1.45 percent of GNP in 1981 to a deficit of 2.01 percent in 1982, was one of the greatest such swings to expansion on the record. Our estimated relations between budget deficits and changes in GNP and unemployment predicted a major swing to economic recovery and lower unemployment in 1983 and on into 1984, and that is of course precisely what occurred.

Prior to both the Fiscal 1986 Congressional Budget Resolution and the Gramm-Rudman program to "balance the budget" by 1991, CBO estimates indicated very large and increasing deficits in the years ahead. August 1985 projections of the official high-employment ("standardized-employment") budget, reduced to a 5.1 percent unemployment rate, showed a deficit of $225 billion by 1990. This corresponds to an actual projected national income account deficit of $258 billion for that year.

Adjustment for price effects, however, brings the high-employment deficit down substantially, to $58 billion in 1986, but shows it rising to $119 billion by 1990. The price- and interest-adjusted deficit in 1990 is projected at $116 billion.

We thus had projections of substantial high-employment deficits over the rest of this decade. The adjustments for anticipated inflation reduced those projected deficits, but still left them high. The projected adjusted deficits, therefore, while initially less than their 1982-84 peaks, were substantial, and turning higher.

Indeed, make no mistake about it. From a historical perspective, these deficits are enormous. From 1986 to 1990 they would *average* 2.15 percent of GNP, while up to 1982 the largest inflation-adjusted deficit we had ever had, in any year since the high-employment series began in 1955, was 0.64 percent. From 1955 to 1981, the adjusted high-employment budget was, on the average, in *surplus* by 1.35 percent of GNP.

Deficits this large, according to my equations -- and probably those of any major econometric model -- imply a considerable excess demand. Unchecked, they would be pushing the economy toward rates of growth of GNP and declines of unemployment -- the latter to negative figures! -- which are clearly unattainable.

Initially, however, it should be recognized that the large deficits would be expected to contribute to a reduction of our 7 percent overall unemployment rate. Once unemployment is driven as low as possible with aggregative measures, further fiscal stimulus would generate inflation. The Federal Reserve would then be expected to tighten the money supply, and interest rates, both nominal and real, would rise.

The curious consequence is that associated declining real market values of the public holdings of government debt would mean that the *real* federal deficit would be reduced. It would have been reduced, however, by an inflation tax rather than explicit tax increases or reductions in government expenditures.

The deficit reductions envisaged in the Congressional Budget Resolution for fiscal 1986 were in fact substantial. With adjustment for inflation, the *high-employment budget*, calculated at an unemployment rate of 5.1 percent, would be brought into balance by 1987, as shown in Table 12, and would be in some surplus in subsequent years. While none of this can be predicted with great accuracy or confidence, it would appear that such a path for the high-employment budget, and the associated relatively moderate actual budget deficits that implies, would be consistent with relatively low unemployment and reasonably non-inflationary economic growth.

The Gramm-Rudman program, on the other hand, envisages, from 1987 on, very drastic deficit reduction. As shown in Table 13, by bringing the actual budget to balance by 1991, it would create a surplus in the official high-employment budget and, most important, very substantial surpluses in the high-employment budget adjusted to include the inflation tax. Gramm-Rudman would, in a real sense, give us high-employment budget surpluses, when adjusted for inflation, comparable to those which have been usually associated in the past with a sluggish economy or sharp recessions.

* * * * * *

Once we get over the notion that deficits are automatic sin, and once we learn to measure them right, a lot of the easy answers have to be rejected. It is not true that deficits must always be reduced. The current mix of fiscal and monetary policy, with high real interest rates and a huge trade imbalance accountable to an expensive dollar is far from ideal. Our budget priorities may be all wrong. But the knee-jerk reaction that wiping out all of the overall official deficit will solve our problems is hard to sustain.

Table 12 Projected High-Employment Budget Surplus or Deficit and GNP, on Basis of Fiscal 1986 Congressional Budget Resolution[a]

(1)	(2)	(3)	(4)	(5)	(6)
Year	GNP	Budget Surplus or Deficit (-)			
		Actual (National Income Accounts)	High-Employment		
			Official	Adjusted for Price Effects	Adjusted for Price and Interest Effects
		A. Billions of Dollars			
1985	3,906	-161.3	-95.9	-36.8	-62.7
1986	4,217	-138.3	-80.6	-15.6	-25.8
1987	4,548	-125.5	-72.3	-0.2	-1.8
1988	4,905	-104.0	-57.6	17.5	15.9
1989	5,289	- 96.8	-57.2	24.1	13.9
1990	5,704	- 84.6	-51.7	33.7	19.7
		B. As Percent of GNP			
1985	100.0	-4.13	-2.43	-0.94	-1.60
1986	100.0	-3.29	-1.91	-0.37	-0.61
1987	100.0	-2.76	-1.59	0.00	-0.04
1988	100.0	-2.12	-1.18	0.36	0.32
1989	100.0	-1.83	-1.08	0.46	0.26
1990	100.0	-1.48	-0.91	0.59	0.34

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[a] GNP, national income account surplus, and "official" high-employment surplus from Congressional Budget Office projections in The Economic and Budget Outlook: An Update (1985). High-employment surpluses have been recalculated at 5.1 percent unemployment. Adjustments have been made on the basis of CBO projections of future prices and Treasury bill rates, and net debt consistent with actual deficits.

Table 13 Projected Future High-Employment Budget Surplus or Deficit and GNP, on Basis of Gramm-Rudman[a]

(1) Year	(2) GNP	(3)	(4)	(5)	(6)
		Budget Surplus or Deficit (-)			
		Actual (National Income Accounts	High-Employment		
			Official	Adjusted for Price Effects	Adjusted for Price and Interest Effects
		A. Billions of Dollars			
1985	3,906	-161.9	-95.7	-37.5	-63.4
1986	4,217	-138.2	-79.5	-14.5	-24.6
1987	4,548	-102.7	-49.3	22.3	23.8
1988	4,905	- 63.2	-16.0	57.3	60.8
1989	5,289	- 31.2	9.1	86.1	84.2
1990	5,704	6.2	39.0	116.6	114.4
		B. As Percent of GNP			
1985	100.0	-4.14	-2.45	-0.96	-1.62
1986	100.0	-3.28	-1.89	-0.34	-0.58
1987	100.0	-2.26	-1.08	0.49	0.52
1988	100.0	-1.29	-0.33	1.17	1.24
1989	100.0	-0.59	0.17	1.63	1.59
1990	100.0	0.11	0.68	2.04	2.01

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[a] GNP from Congressional Budget Office projections in The Economic and Budget Outlook: An Update (1985). High-Employment surpluses have been recalculated at 5.1 percent unemployment. Adjustments have been made on the basis of CBO projections of future prices and Treasury bill rates, and net debt consistent with actual deficits.

The federal budget deficit has become in some circles the hottest political issue since Vietnam. Democrats and Republicans echo each others' proclamations of disaster and largely restrict their differences to their proposed remedies, and the casting of blame. Scoring political points has replaced almost all efforts at sober economic analysis.

Deficits do matter but to know how and how much you have to measure them right. And deficits can be good as well as bad.

The public has feared that budget deficits add to their own debt burden and that of future generations. What we really bequeath to the future, however, is our physical and human capital. A "deficit" which finances construction and maintenance of our roads, bridges, harbors and airports is an investment in the future. So are expenditures to preserve and enhance our natural resources or to educate our people and keep them healthy. Federal budgets which are balanced by running down our country's capital or mindlessly selling public assets to private exploiters are real national deficits.

As for that bottom line on what to do about the current federal deficit, it depends. If we were to realize the projections of the fiscal 1986 Joint Congressional Budget Resolution, and we are seriously committed to a high-employment economy, we would probably have gone far enough in overall budget cutting. The increase in debt for the last five years has been such that even our slower rate of inflation generates a substantial inflation tax. The inflation tax rate is less, but the public debt on which it is paid is more.

Inflation-adjusted budget deficits, on the basis of the budget resolution projections, did not promise to be unduly large. For those that highly prize economic growth and low unemployment, the risk of insufficient fiscal stimulus must be weighted heavily. One cannot properly counsel budget-balancing in an economy with unemployment still at seven percent and real economic growth well below its potential. A budget balanced by current Federal rules of accounting is an invitation to the worst economic downturn in half a century.

The budget mix is another matter. We may wish to spend more on investment in our public infrastructure and human capital and less on subsidies and support to those with the most political clout. We may also wish to devote more to our nation's welfare and less to warfare. And we may wish to finance our expenditures with a more equitable tax system.

With a sound and balanced fiscal policy, we should look all the more to a monetary policy which permits the economy to move at full speed. No artificial shortage of money should be allowed to drag down private investment or so distort the value of the dollar as to cripple the significant sectors of the American economy which do and should compete in world markets.

A competitive, market-oriented economy is capable of stunning successes. But there remains a major role for government policy to insure the aggregate demand necessary for full employment and maximum growth. With correct measures, the macroeconomic theory of the past half century can continue to point the path.

Mr. Rowen. Thank you very much, Dr. Eisner.

Our next panelist is John Makin, the Director of Fiscal Policy Studies at the American Enterprise Institute here in Washington, and he's also professor of economics at the University of Washington.

PRESENTATION OF JOHN H. MAKIN

Mr. Makin. Bart Rowen has promised to be very strict with us on time, so let me try if I may presume to pick up where Bob Eisner left off, I think what he was saying was that when you look at an appropriate target for a deficit it's not zero in the conventional sense, and I say this with some hesitation here on the hill because I'm sure a lot of congressmen and senators will say, "My God, economists have been up here moaning and groaning about the deficit for 5 or 6 years and now we do something about it with Gramm-Rudman and they say you've gone too far."

But I honestly think that is the bottom line, that Gramm-Rudman goes too far. And let me put my conclusion up front since I may get cut off at the end, and that is, that we are supposed to talk about appropriate targets for deficits and effective means of achieving them.

The appropriate target for the deficit in 1991 is about $100 billion. That takes account of a number of factors which I think are related to the harmful effects of deficits which I don't have time to go through here in detail but which are outlined in some detail in my paper.

The effective means of reducing the deficit are either to cut spending or raise taxes. I don't think that will ever change. But there are certainly different ways to cut spending and people will argue a lot about that.

Having put my basic conclusion on the table, I want to try to maximize the value that I add to this discussion because I think many others will address the traditional area of topics and talk about the international implications of Gramm-Rudman and moving to a budget-balancing strategy because I don't think this is going to get enough attention. I put it at the end of my paper like everybody else does—by the way, we should think about international implications—but I think if you look back at the period from 1946 to 1986, perhaps one of the biggest changes in the American economy has been its internationalization which has included a reduction in our relative prominence in the world economy.

So I will move quickly and efficiently by reading in what I hope is an interesting way. In the light of post-war experience with fixed and floating exchange rates and the need if not the ability to coordinate macroeconomic policy among major countries, it would be a serious error not to consider the international implications of stabilizing debt to GNP over a period of 5 years, which is, by the way, what would imply about a $100 billion deficit in 1991.

First, this means setting fiscal policy on a rigid, less expansionary path, leaving the remaining degree of freedom to coordinate policy with other nations' monetary policy. A tighter fiscal policy, such as would be implied by moving to a lower deficit and stabilizing debt to GNP, should result in gradually declining real interest rates, continued depreciation of the dollar, all barring major policy changes abroad. The trading advantage implicit in a strong dollar enjoyed by America's trading partners would erode, as it already has, and it is worth considering how they might respond. That is, we often set policy in the United States and assume that everybody else is going to sit around and do nothing. If we move aggressively to depreciate the dollar, we are already beginning to see that our trading partners worry about the loss of their competitive advantage. What might they do?

For countries in the industrial world to try to preserve their competitive edge, providing that U.S. monetary policy remains aimed at stable or falling inflation, they would pursue more expansionary monetary policy in order to attempt to redepreciate their currencies against the dollar and, in fact, this week's G-5 discussion may get into that very issue.

The United States is anxious perhaps to push for more expansionary monetary policies abroad in order to push for more expansionary monetary policies at home. That could be a dangerous policy.

As a result of possibly more expansionary monetary policies abroad, there arises the possibility that at some time during the next half decade the United States will face a double temptation to follow more inflatinary policies.

One part of the temptation will be the already noted inflationary tax on outstanding debt. Since I haven't already noted it, let me explain. If you get inflation to go up faster than people anticipate it, that's a good way to reduce the burden of deficits because in effect you impose a tax on the people who buy Government securities.

The other implication would be the desire to maintain or restore a competitive advantage that comes from currency depreciation which in turn results in faster money growth. Such a temptation for the U.S. monetary authorities should be avoided since ultimately a global monetary expansion would risk a return to the destabilizing conditions of the late 1970's where monetary assets were dumped and the rush for commodities led to the excesses that resulted in the debt crisis, the failure of many American banks heavily involved in energy loans, and the extreme difficulties in the S&L and agricultural sectors today.

This all reveals a very basic point about inflation. Unless there's a willingness to keep accelerating it and to move on to hyperinflation, there are really no net benefits from starting down the inflationary road. Therefore, it's worthwhile to anticipate the conditions under which inflationary policies may seem expedient; that is, too extreme a deficit target under Gramm-Rudman.

Now what about the gold standard, everybody's—not everybody's favorite—some people's favorite. Gold or commodity standards have often been suggested, but as we saw in 1971, a gold standard which is not binding provides no discipline. That is, if you simply say when it becomes inconvenient we go off the gold standard, there's really no point in having one. Further, there's no guarantee that a gold standard controls inflation. A gold standard can be the basis for starting a high inflation by simply starting off with a premium price of gold. You have a premium price of gold that the

Government sets, everybody sells their gold to the Government, the monetary base against which money is allowed to be issued under the gold standard goes up, and you have more inflation.

Further, it's important to recognize that if fiscal policy constrained by the desire to stabilize debt to GNP—that is our target—or achieve some other deficit goal is accompanied by a move toward fixity of the exchange rates, witness the discussions that are now going on—we need more fixed exchange rates—then, in a formal sense—and this is where models are useful. It's not useful just to play around with a model and not get anything out of it. But if you look at the way the system has to operate, if you simply set fiscal policy on a fixed path and fixed exchange rates, then monetary authorities have to be passive. That is, you've either got to coordinate monetary policies or you're going to have a lot of pressure for exchange rates to change.

So if we set fiscal policy on a fixed path, in my view, it's not a good idea to fix exchange rates since then you essentially constrain monetary policy.

The yellow light says to move on to the overall conclusion, which is that a combination of stringent targets for fiscal policy and exchange rates fixity reduces the discretion of the monetary authorities at a time when more discretion may be desired. Exchange rates fixity therefore requires binding constraints on the separate actions of monetary authorities. In other words, Gramm-Rudman is going to constrain fiscal policy for 5 years and if we want to have some discretion with monetary policy we'd better think hard before we fix exchange rates.

Thank you.

[The complete presentation of Mr. Makin follows:]

Reducing the Deficit:
Appropriate Targets and Effective Means*

John H. Makin
American Enterprise Institute

*Prepared for the Symposium on the Fortieth Anniversary of the Joint Economic Committee as established by the Employment Act of 1946.

The author is also Professor of Economics at the University of Washington in Seattle and a member of the Congressional Budget Office Panel of Experts. Any views expressed are his own and should not be interpreted as views of any of the institutions with which he is associated.

I. Introduction

The forty years since passage of the Employment Act of 1946 have seen Congress persist in the legislative approach to solving what are fundamentally economic problems. The Employment Act of 1946, as Herbert Stein has appropriately noted in his scholarly treatise on fiscal policy, The Fiscal Revolution in America, was not the Full Employment Act of 1946, although it was amended by the Full Employment and Balanced Growth Act of 1978. It did, however, acknowledge that the government should use economic policy instruments to keep unemployment low. In the years since 1946 the Employment Act is probably best viewed as a persistent reminder to economic policy makers that inflation is not the only economic problem they have to worry about. For economists the Employment Act of 1946, enacted ten years after Keynes' assertion that markets did not guarantee full employment, represented acknowledgment of that view by the legislative body of the world's leading economy.

As an economist with a deep skepticism about legislative approaches to economic problems, I cannot resist observing that the forty years since passage of the Employment Act of 1946 have seen a gradually rising rate of unemployment: 4.4 percent in the 1950s, 4.7 percent in the 1960s, 6.1 percent in the 1970s, and 8.2 percent thus far in the 1980s, assuming a 7.0 unemployment rate for 1985. Of course a simple recitation of such figures grossly oversimplifies the progress of the "unemployment situation." The four decades since 1946 have seen massive changes in demographics and the labor force, including a sharp increase in two-earner families, rapid increase in labor-force participation of women, liberalization in real terms of unemployment benefits, all of which have contributed to an increase in the measured unemployment rate more than they have to an increase in the unemployment "problem."

As we enter 1986, we have before us the Gramm-Rudman-Hollings bill (hereafter GRH) which represents a legislative attempt to deal with another economic problem, the deficit. In principle, Congress ought to be able to deal with the deficit problem more successfully than it has with the problem of unemployment. After all, Congress ultimately sets expenditures and revenues; the difference between which measures the deficit. If Congress passes a law that mandates elimination of deficits over a five-year period, it is simple mechanically to envision a steady progression of spending cuts and/or tax increases that satisfy the mandate.

Beyond the superficial appeal of the mechanical approach to deficit reduction--the legal approach, if you will--there remain some serious issues yet to be resolved. Federal government spending consists primarily of four categories: entitlements including Social Security, about 43 percent of total spending; defense, about 16 percent; interest on the debt, about 14 percent; and "all the rest" or nondefense discretionary, about 17 percent.[1] The GRH approach to deficit reduction exempts well over half of spending from its spending reduction requirements, thereby mandating that if required deficit reduction is to be achieved on the spending side, nonexempt areas including large portions of the defense budget will be subject to annual spending cuts of five to ten percent in nominal terms and even greater cuts in real terms as inflation erodes the purchasing power of the dollars earmarked for nonexempt areas of spending.

These unpleasant facts about spending suggest to some observers that either a tax increase is inevitable or the judiciary will enter the

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[1] As estimated by the Congressional Budget Office for FY 1986, August 1985 Economic and Budget Outlook, p. 68.

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budget debate and declare GRH unconstitutional. Surely if the agreement to exempt over half of total federal spending is adhered to and if the economy doesn't move into an unprecedented era of rapid, noninflationary growth, elimination of the deficit by 1991 will require a tax increase. This bald fact throws into sharp relief the issue of just what deficit target makes economic sense. We have, after all, survived 24 of the last 25 years with deficits over a prosperous, although atypically inflationary, period. It may be that the deficit, however it is measured, is neither the only nor the primary thing we should be watching to gauge the stance of fiscal policy or to set goals to move out of an era of unprecedented peacetime deficits.

There also arises the issue of whether to cut deficits by cutting expenditures or increasing revenues. Under our current tax system, with its many distortions and inequities, collecting another dollar of tax revenue by magnifying those distortions costs the economy about $1.40. This view is not accepted by all economists, but it was included in last year's Report of the Council of Economic Advisers to the president.[2] Suffice it to say that if there is anything to this view and it is decided that revenue increases are necessary to reduce or eliminate the deficit, then some consideration should be given to concentrating initially on spending cuts to meet deficit reduction targets while also moving toward a more neutral tax system so as to minimize the cost of drawing more revenue from the system later on.

Whatever one's view may be on the legislative approach to deficit elimination, it is clear that our commitment to that goal will be

[2] Annual Report of the Council of Economic Advisers, Feb. 1985, p. 79. See studies by Stuart (1984), Ballard, Shoven and Whalley (1985), and Browning (1986).

severely tested in the coming months and years. Therefore, it is a very good time to review current thinking on deficits and their relationship with the economy. This brief essay first examines four basic questions about deficits. Should we alter the way in which we measure deficits? Do deficits matter, which is a subset of the fundamental question of whether discretionary macro policy matters? Should we aim for a zero deficit and what are the major differences between spending cuts and tax increases as a means to reduce the deficit? After addressing these questions, I will suggest the outlines of an operational approach to fiscal policy which takes account of the many advances in economic thinking on deficits that their rapid increase has provoked. Surely it is safe to say that the deficit in the 1980s has absorbed a great deal of the time and energy of both economists and legislators. It would be unfortunate to admit that an era of unprecedented peacetime deficits has yielded no useful lessons for the future.

II. Deficit Measurement

A number of economists, prominent among them my fellow panelist Professor Eisner [see Eisner (1984) (1985) and Dewald (1985)], have suggested that if the usual measure of the deficit is adjusted for changes in the value of government assets and liabilities, a much different picture emerges regarding the post-war stance of fiscal policy than that suggested by a simple measure of nominal deficits.

Professor Eisner's work may be said to follow in the tradition begun with the concept of the full-employment deficit whereby the simple nominal deficit was modified to serve as a better guide to use of discretionary fiscal policy. Under that view, we expect to see deficits during economic slowdowns and surpluses during the phase of rapid expansions. Therefore, at any moment the appropriate measure of the deficit for policy purposes is that which would emerge at "full employment." While that concept has been plagued by considerable disagreement over the definition of full employment, it is still useful to bear in mind as a check against attempting to eliminate a deficit in the midst of a recession or going off on a euphoric spending spree at the peak of an expansion.

Professor Eisner's modification of deficit measurement goes well beyond the "full employment" concept. Eisner argues, correctly I believe, that looking at the deficit alone to measure the stance of fiscal policy is akin to judging the economic status of a corporation by looking only at the income statement and ignoring the balance sheet. The primary thrust of Eisner's new view of the federal deficit is to point out that since inflation cuts the value of the large outstanding debt of the government, inflation-induced changes in the value of debt should be subtracted from or added to conventional measures of the deficit. This means that when inflation accelerates and the real value of outstanding debt is depressed, the deficit is smaller than conventional measures would indicate. The new view also suggests that higher interest rates, which may add to the deficit by increasing interest expense on new debt, may also reduce the debt burden since they are associated with a lower value of the large stock of outstanding debt. The new view also reminds us, consistent with the balance sheet analogy, that government debt may be used to finance either asset acquisition, which increases the government's net worth, or straight consumption. In the former case, where government capital expenditure may leave unaffected or actually enhance the government's net worth, the flow measure of a deficit is misleading.

Professor Eisner has recalculated price- and interest-adjusted measures of the federal deficit for the period 1955-1985 and found a strong relationship between lagged measures of the new view of deficits and economic activity in the form of the percent change in gross national product and the change in the rate of unemployment. To put it more difectly, the new view suggests that fiscal policy indeed does matter, notwithstanding the claims of the rational expectations school that systematic macro policy is ineffective and the claims of the monetarists that only money matters. Professor Eisner finds that both fiscal policy and money matter, but that fiscal policy matters more when expansionary fiscal policy is taken to rise in proportion with deficits measured under the new view.

The idea that the balance sheet and changes in net worth associated with changes in the real value of assets and liabilities must be incorporated into flow measures such as deficits to determine economic behavior is a fundamental one. Professor Eisner's new measures of deficits suggest that the posture of fiscal policy was very stimulative, that is, deficits were very large in the period after 1981. This change was due to a combination of very large measured deficits and a deceleration of inflation which reduced the value of outstanding government liabilities.

My primary reservation with regard to the new view of deficits comes from the possible destabilizing, countercyclical implications. Professor Eisner observes that under his measure there were no budget deficits between 1977 and the end of 1980. This is partly due to a combination of moderate measured deficits and a rapid acceleration of inflation, with accompanying higher interest rates. Should fiscal policy have been made more stimulative during that period, and if it were, would not more inflation have further blunted the stimulative effect under Professor Eisner's measure? Would that call for still further stimulation of fiscal policy? In other words, inflation-adjusted deficit measures carry the possibility of destabilizing prices by calling for a more stimulative posture during periods of high inflation and less stimulative posture during periods of deceleration of inflation or deflation.

We shall return to these questions and others after I briefly consider a more fundamental attack on countercyclical policy contained in the rational expectations view and then expressing my own views on an appropriate criterion for fiscal policy and its implications for a deficit target.

III. Do Deficits Matter?

Beyond the measurement issue is the question of whether deficits, or more generally, the stance of fiscal policy, really have any effect on the path of economic activity. The rational expectations school in its most extreme manifestation claims that a combination of perfect foresight and intergenerational altruism combine to suggest, for example, that if taxes are cut in order to stimulate the economy while expenditures are left unadjusted, rational citizens will anticipate higher future taxes and increase their saving in order to pay those taxes. Debt-financed increases in government spending work essentially the same way. Rational citizens anticipate that they or their heirs will have to pay interest and principle on the debt and thereby set aside additional assets to service and amortize the debt. The assumption of intergenerational altruism is necessary since without it long-term government financing could mean that deficit finance creates a net increase in demand, provided that citizens are indifferent about future taxes which may be levied on their children or their children's children.

Rational expectations is often characterized as the neoclassical view in the sense that it returns us to the pre-Keynesian or classical view about discretionary macro economic policy. In both the classical and neoclassical schools of thought, anti-cyclical monetary and fiscal policy measures are useless, although for different reasons. The classicals' view was that the economy would move to a full employment equilibrium on its own while the neoclassicals hold that systematic efforts to alter the path of the economy will, because they are systematic, come to be fully anticipated and therefore will be ineffective.

The neoclassicals are left in an awkward position in two ways. Macropolicy measures need to be unsystematic to "work," which in terms of the overall goal of smoothing business cycles means sometimes smoothing and sometimes not, even sometimes destabilizing, all in a random manner.[3] This is hardly a comfortable role for policy makers charged with keeping the economy on an even keel, although their persistent efforts to this end may in fact have been clumsy enough to satisfy the neoclassical condition for there to have been real economic effects from such measures.

[3] This is not strictly true if one includes the possibility of intertemporal substitution of work effort caused by changes in government spending. See Aschauer (1985).

The second awkward problem for the neoclassical school has been the persistence of business cycles or, more precisely, the persistence of any systematic movement around trend of macroeconomic variables like GNP. If rational agents anticipate all regular movements, then they ought to be eliminated. The best example is the length of lines at supermarkets. Since busy shopping times are well known, the number of checkers can be altered to keep the length of lines constant. I cannot resist adding that perhaps whatever it is that keeps the number of checkers below maximum during "rush" periods is the same thing that prevents "ultrarational" behavior from eliminating regular business cycles.

The deficits-don't-matter school, ably represented by Robert Barro (1974) and others, has provided economists with useful food for thought and has checked an overly hysterical statement about the evils of deficits. I will venture into the risky area of attempting to characterize a consensus on the rational view of deficit finance by saying that while most economists acknowledge forward-looking behavior on the part of households and firms, they are not convinced that the full rationality required for the proposition that deficits "don't matter" produces hypotheses consistent with observable behavior. That is, most economists still believe that deficits do matter and that, eventually, very large deficits, appropriately measured, can lead to serious problems.

IV. A Zero Deficit?

Measurement and "mattering" aside, there remains the question of how much to cut deficits, given that we agree on an appropriate measure and are skeptical of the full rationality viey that deficits don't matter. It is interesting that GRH, in seeking a balanced budget irrespective of the state of the economy, represents a return to what might be characterized as the pre-war view that deficits are bad and should be eliminated come what may. Since GRH is constituted in terms of the usual way in which we measure deficits, it brushes aside the legitimate issues of measurement while rejecting the notion that deficits don't matter. It also appears to reject the concept of a full or high-employment deficit whereby cyclical factors are used to adjust the deficit target. While there is some mention of rescission of GRH provisions in the event of a recession, the ultimate target of zero deficit in 1991 would presume on grounds of high-employment deficit measurement that the economy will be midway between a recession and a boom at that time. Otherwise, it would aim for a surplus in the event of a boom or a deficit in the event of a recession. Needless to say, it is unfair to require forecasting of the state of the economy five years from now, but since no administration has ever forecast a recession, some concern about a prospective linear path of deficit-reduction seems warranted.

The controversy among economists over measurement of the deficit, whether or not deficits matter in the first place and how to cut the deficit, suggests that legislators, or presidents for that matter, who are looking to economists for guidance on concrete policies to follow and the economic effects of deficits may be forgiven some frustration. Whether or not we are about to eliminate deficits, it surely is clear that since 1981, the federal deficit has been extraordinarily large by post-war standards. In addition, the "policy mix" has been unusual. Highly expansionary fiscal policy coupled with what, until last year, could be characterized as restrictive monetary policy is an atypical mix akin to keeping a fiscal foot on the accelerator while the monetary foot is on the brakes. Any economist familiar with the numbers who has tried to use historical relationships to forecast the economy during the '80s will tell you, with a good deal of humility, that something certainly has changed.

In my view, the most reliable measure of the stance of fiscal policy and its effects on the economy is the ratio of the national debt to GNP. Since 1981 a rapid increase in that ratio, not accompanied by a slowdown in the issuance of debt by state and local governments, the private sector or other major industrial countries, has coincided with higher real interest rates and prospective tax increases that discourage investment and therefore create a drag on growth of output and productivity of the labor force. The debt-to-GNP ratio also provides a good measure of the level of interest on the national debt as a share of total government spending. More debt means that more of existing tax revenues must go simply to pay interest on the debt, thereby requiring either a tax increase or a reduction in other programs if they are not to contribute further to the deficit in a self-reinforcing manner.

It is worth noting that the debt-to-GNP criterion to measure the stance of fiscal policy, together with the advances in attempts to measure the deficit in an economically meaningful way and the reliance on some rationality in the private sector, all suggest that post-1981 deficits are too large and should be reduced. But it is also probably true that deficit reduction is subject to diminishing economic returns. The highest returns come from deficit reduction down to about two percent of GNP, which is consistent with stabilizing the ratio of debt to GNP. Further deficit reduction may be deemed desirable, but those advocating it should be aware that the net returns in terms of economic performance will diminish sharply and may even become negative. Further, the effect of budget policy on the economy cannot and should not be analyzed without paying careful attention to tax structure. It would be highly misleading to look only at deficits or the relationship between debt and GNP in the period after 1981 and the relationship with net investment without simultaneously considering front-loaded investment incentives that were built into the tax changes enacted in 1981.

V. Toward a Theory Underlying a Target for Deficits

If you want to know how unsure economists are about an appropriate target for deficits during the 1980s, ask them whether, if next year sees a recession, it would be better for the economy to continue on a path toward lower deficits or to follow traditional countercyclical measures which would increase the deficit. Some would argue that trying to reduce deficits in a recession would only make it worse, while others would argue that given that deficits are so large, the favorable effect of prospective deficit reduction would stimulate private-sector demand by more than enough to offset the reduction in government demand implicit in deficit reduction.

In view of this uncertainty and in view of my perspective on the economic effects of deficits through their impact on the ratio of debt to GNP, I would argue that the way out of this conundrum would be to set ourselves on an intermediate path toward stabilizing the ratio of debt to GNP. This in turn would mean aiming initially for deficits at about two percent of GNP. This position puts me somewhere between those who would press forward on a path to a balanced budget in the midst of economic weakness and those who would suspend any progress toward lower deficits during that period.

Over the long run after the initial phase of five or six years in getting deficits down to a level consistent with a stable ratio of government-debt-to-GNP, I would begin to target zero average deficits. That is, I would aim for a mild countercyclical stance of fiscal policy with deficits during recessions and surpluses during expansions, such that the sum of their values over a period like a decade would be approximately zero. The result of this policy would be a gradual decline in the ratio of debt to GNP and a gradual reduction in the role of the federal government in securities markets. I emphasize that this latter step is not necessary to economic well-being; rather it is prudent in the light of the long-run considerations such as wars or major economic slowdowns wherein governments must borrow very heavily. A gradual drop in the ratio of government-debt-to-GNP seems a prudent way of keeping that option open.

There are a number of problems with this approach. The first arises with regard to setting an appropriate level of debt to GNP as a target. Theory provides little guidance here, but our experience during the 1980s suggests that a rapid increase in the ratio to over 40 percent is accompanied by high real interest rates which in turn have a negative effect on capital formation. I emphasize that rapid changes in the ratio of debt to GNP carry more implications for short-run economic behavior than does the level of debt to GNP. The level of debt to GNP, if it is very high, does however constrain government options in dealing with unforeseen events just as a debt-laden household faces constrained options in the face of an unusually long sequence of negative economic events.

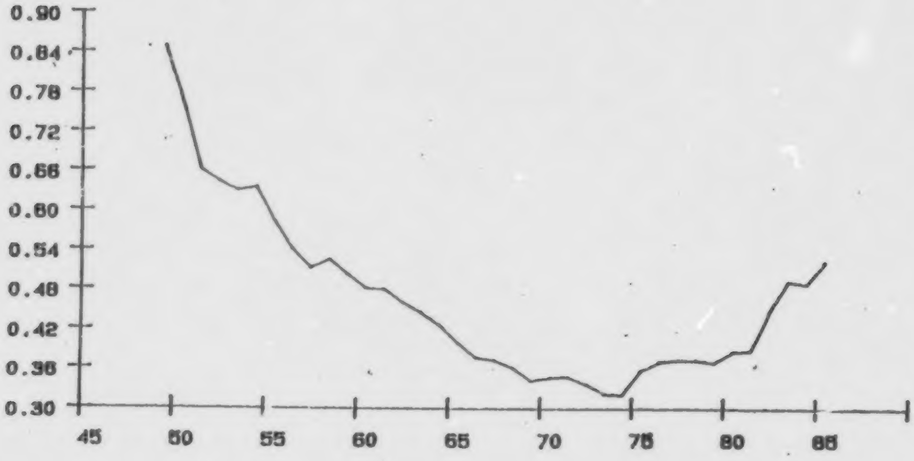
Of course, in discussing the ratio of national debt to GNP, it is important to consider the behavior of private debt as well as debt in other countries. It would be somewhat misleading to attribute to a rapid rise in government debt accompanied by a rapid drop in private debt the same economic consequences of a case in which both public and private debt are increasing rapidly. As it turns out, the 1980s has been a period during which relative to income levels, both U.S. government debt and private debt have been increasing rapidly. See Charts I and II. The same has been true of central-government debt relative to GNP in other major industrial countries. See Chart III. The rapid run-up of developing countries' debt relative to their incomes during the period prior to 1982 is well known, and while the increase in that debt has been curtailed, it has continued to climb as interest payments are capitalized into additional debts.

All of these considerations suggest that in setting deficit targets, it is important to avoid deficits large enough to increase the overall ratio of debt to GNP. U.S. government deficits since 1982 have been large enough to fulfill that criterion. The deficit target over the next five years should be such as to stabilize the overall ratio of debt to GNP under prudent assumptions about the ability of the economy to grow.

It is possible and perhaps useful to cast the focus placed here on the ratio of government debt to GNP in the context of a neoclassical model of the determinants of business investment. An investment measures the increase in the capital stock which in turn combines with

Chart I

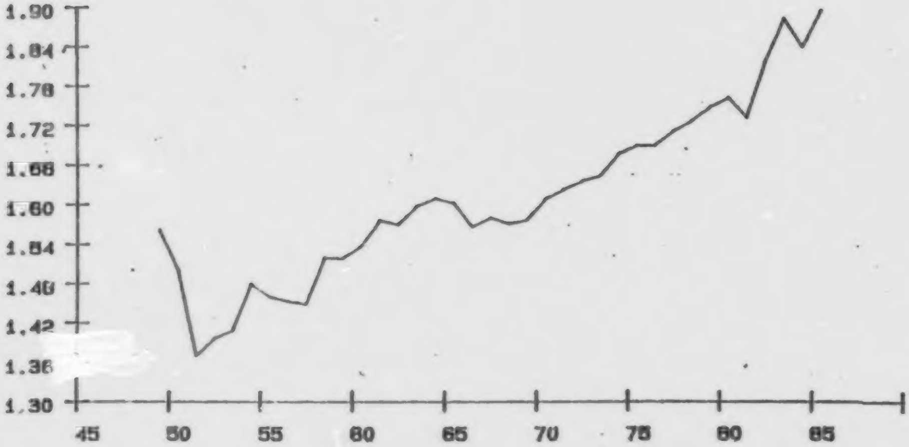
U.S. Government Debt/GNP



Notes: Calendar Year. 1985 Est Based on Qtrs 1, 2.

Chart II

Total Debt/GNP



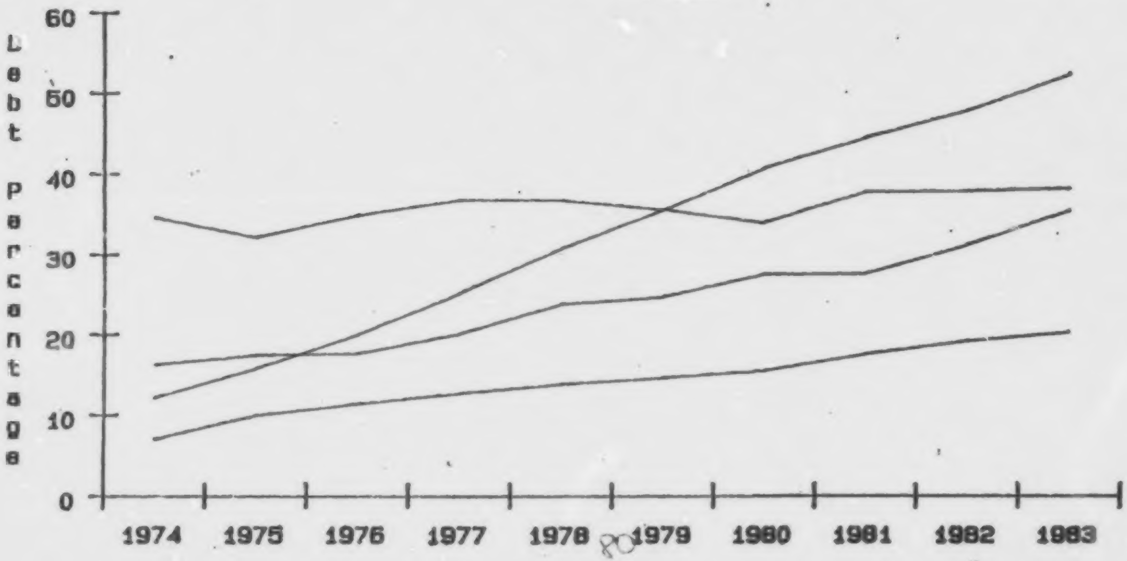
Notes: Calendar Year. 1985 Est Based on Qtrs 1, 2.

Chart III

Ratio of Total Central Gov't Debt to GDP/GNP:

Canada, West Germany, Japan, United Kingdom

1974-1983



growth in the labor force and advances in knowledge and technology to determine the growth rate of the economy.

The details of this theoretical approach are fully enumerated in Makin (1985) and Makin and Sauer (1985). The neoclassical approach to investment begins by deriving an expression for the desired stock of capital that is proportional to the ratio of output to the user cost of capital. The user cost of capital in turn is determined by a combination of the real rate of interest and tax factors such as investment tax credits and accelerated depreciation relating to the prospective tax burden on income from an investment project. When output rises or the user cost of capital falls, the desired capital stock is increased and investment undertaken.

A rise in the debt-to-GNP ratio increases the user cost of capital and depresses investment for two reasons. First, the higher ratio of debt to GNP increases the real interest rate. This result, articulated by Blanchard (1984), is conditional on less than full intergenerational altruism since in that case debt accumulation results in expected future taxes and adjustments in saving behavior suggested by the rational expectations school. The theory of investment propounded here suggests also that government debt relative to GNP, as opposed to overall debt relative to GNP, may have a particular significance for private investment. An increase in the ratio of government debt to GNP and the resulting increase in revenue required to service it may result in the expectation of higher effective average tax rates on capital through higher statutory rates on corporate income, or more likely through rescissions or modifications of accelerated cost recovery provisions or investment tax credits such as those proposed in 1984 and 1985 by Treasury, White House, and Congressional tax reform plans.

Viewed in this way, the ratio of government debt to GNP, as a determinant of the real interest rate as well as pressure on expected average tax rates, serves as a proxy for both elements of actual and expected user cost while it simultaneously indicates a link between deficits and capital formation. Deficits large or small enough to raise or lower that ratio will, according to this view, reduce or increase the desired capital stock. Tests of this proposition suggested that a deficit sufficient to increase the change in the federal-debt-to-GNP ratio by one percentage point would reduce investment by an annual rate of $25 billion (1984) spread over five quarters. In fact, this response of investment to the change in the federal debt to GNP implies a volatile path of investment not unlike that typically observed in the United States. The total undiscounted investment loss over the five years between 1980 and 1985 attributed to the rapid run-up in debt to GNP is, according to this method of estimation, about $50 billion.

An important corollary to these results is that stabilization of the ratio of federal debt to GNP, which would produce a sharp deceleration in its increase, would result in a temporary rise in investment that in turn would help to counteract losses accumulated during previous periods when the rise in federal debt to GNP was accelerating. The stimulative effect on investment would also tend to counteract the negative effect from the reduction in aggregate demand that would come from deficit reduction. It is this result that leads me to recommend deficit targets that are consistent with moving toward a stable debt-to-GNP ratio, even during an economic slowdown. The alternative, a sharp deficit increase made sharper by the negative impact of slower economic activity on federal revenues, would produce a sharp run-up in the debt-to-GNP ratio that, particularly given the rapid rise in debt over the past five years, could mean a net negative impact on overall economic activity. I hasten to add, or confess if you like, that in my view economists do not have sufficiently accurate measurement of the net effect of these two opposing forces to prescribe with confidence the appropriate alteration, if any, of a deficit-reduction measure in the event of a recession on the way to achieving some deficit target. That uncertainty calls for prudence, and for that reason I propose rather than deficit elimination, a more modest target of a deficit consistent with stabilization of debt to GNP over a period of five years.

Stabilizing the ratio of debt to GNP would mean aiming for a deficit target of around $90 billion in 1991 rather than the zero specified by GRH. Prudence on the other side, that is, avoiding a dramatic move toward stimulative, countercyclical policy, seems appropriate in the light of the rapid run-up of government debt in recent years. In a way, by pursuing a highly expansionary fiscal policy throughout the expansionary phase of the current cycle, we have used up an instrument at the least appropriate time. That leaves open the question of whether it ought to be applied during a more appropriate time, say, a recession; but in my view some moderation is in order.

The view expressed here of the desirability of avoiding a rapid increase in the debt-to-GNP ratio is based on the negative effect on investment and capital formation. Some have argued that the contribution of raw capital formation to growth has been small relative

to that of growth of the labor force and advanced in technology. Still, it is important to bear in mind that although the cost of less investment in terms of forgone aggregate consumption may be difficult to estimate, the social value of a dollar of investment exceeds a dollar when taxes on income from capital keep the marginal return from investment above its marginal social cost. Studies by Lind (1982) and Halvorsen (1985) explore at length the question of the consumption value of a dollar of investment. The basic reason for this multiplier effect, totally unrelated to the Keynesian multiplier, is that an additional dollar of investment results in a net addition to current and future income, part of which is saved and thereby further enhances the value of investment. Halvorsen (1985) estimates that for a plausible range of the effective marginal tax rate on income from capital between 35 and 65 percent and a range of the estimates of the marginal propensity to save from 5 to 15 percent, the social value of a dollar of investment ranges from $1.50 to $4.25.

Three being a rough mean of the range of these estimates, the implication is that the changes in the debt-to-GNP ratio from 1980 to 1985 that produce a cumulative investment loss resulted in a cumulative consumption loss of $150 billion. Under this same view, pre-GRH prospective deficits from 1986-89 represent an additional consumption loss equivalent of $96 billion for a total 1980-89 estimated consumption loss from deficits amounting to $246 billion in 1984 dollars. This not inconsequential figure could be enlarged under the alternative whereby further cuts in the growth of the debt-to-GNP ratio resulted in further stimulation of investment.

This sketch of investment behavior during the 1980s would be incomplete without additional special reference to the investment incentives measures contained in the ERTA legislation in 1981. A ten percent investment tax credit and enhanced acceleration of depreciation measures, even as modified by TEFRA in 1982, resulted in a sharp drop in the after-tax user cost of capital, particularly in the equipment class. The result was an increase in the desired capital stock which led to sharply increased purchases of capital equipment during 1983 and 1984. The structural changes in tax policy for a time offset the depressing impact on capital formation of the rapid run-up of debt to GNP. As a result, investment was very strong, and it along with strong consumption expenditure contributed to a robust economy during 1984. The effects of such incentives, however, are temporary. Once the desired increase in the capital stock is purchased, their stimulative effect ends. A sharp slowdown in investment spending contributed to a slower growth rate in 1985 well below levels that had been predicted at the beginning of the year.

It is also important to remember that the 1983-84 investment boomlet seemed sharp because it began from a very low level. Perhaps more interesting is the question of why investment had become so depressed by 1981 rather than why it had moved back part of the way toward normal levels in subsequent years. In my view the secular impact of actual and prospective sharp increases in the ratio of debt to GNP may be part of the answer. Constant revision of the tax code may also have depressed investment, particularly that concentrated on long-lived projects outside of real estate. In any case, had a stable debt-to-GNP ratio been combined with the investment incentives enacted in 1981, the investment boom would very likely have been larger and more sustained and the average growth rate for the 1980s might have been closer to the four percent widely forecast rather than the two percent actually realized.

VI. Determinants of the Debt-to-GNP Ratio

If it is determined that targeting a stable ratio of debt to GNP ought to guide fiscal policy and attention to deficits, it is important to understand thoroughly the determinants of the debt-to-GNP ratio. Of necessity, those determinants include tax and spending policies, the level of interest rates, the growth of the economy, and the relationship between actual inflation and the inflation that buyers of government securities anticipate when they lend money to the federal government. If we identify the determinants of growth of the debt-to-GNP ratio, it then becomes easy to identify conditions that have to be met to stabilize that ratio. Then we can go on to look at the deficit outlook in order to see whether realistic or desirable economic conditions could stabilize the debt-to-GNP ratio.

The growth of the debt-to-GNP ratio is determined by the sum of two components: the ratio of the primary deficit (government spending on all but interest minus tax revenues) to the national debt, plus the difference between the interest rate on the debt and the growth of GNP. Call the first the "primary revenue gap" and the second the "interest-growth gap." Both can take on positive or negative values, but the prospects for a negative primary revenue gap seem remote at present, notwithstanding the GRH provisions.

The rate of growth of the debt-to-GNP ratio, in terms of the "two gaps," is derived as follows: the deficit or change in federal debt is written as the sum of interest payments on the national debt plus the primary deficit, or

$$\Delta D = iD + G - tY \qquad (1)$$

where
D = national debt
i = nominal interest rate on debt
G = average government expenditure
t = average tax rate
Y = GNP .

Dividing (1) by D and subtracting the rate of growth of GNP, $\Delta Y/Y$, gives the rate of growth of the debt-to-GNP ratio expressed in terms of the primary revenue gap and the interest-growth gap.

$$(\Delta D/D - \Delta Y/Y) = \underset{\text{("primary revenue gap")}}{\frac{G - tY}{D}} + \underset{\text{("interest-growth gap")}}{i - (\Delta Y/Y)} \qquad (2)$$

Equation (2) can be usefully manipulated to express the growth of the debt-to-GNP ratio in terms of the primary revenue gap and a different but equivalent expression for the interest-growth gap. Since the nominal interest rate is equal to the real rate plus anticipated inflation and the growth of nominal GNP is equal to the sum of inflation and real growth, it is possible to rewrite the expression for the growth of the debt-to-GNP ratio as

$$(\Delta D/D - \Delta Y/Y) = \frac{G - tY}{D} - [(\Delta x/x - r) + (\pi - \pi^*)] \qquad (3)$$

where
$\Delta x/x$ = real growth rate
r = real interest rate: $i - \pi^*$
π = actual inflation rate
π^* = expected inflation rate

Equation (3) provides some useful perspective on behavior of the debt-to-GNP ratio. Essentially it says that if the primary deficit is not zero, that is, if government spending exceeds its revenues by more than interest on the debt, either the economy has to grow at a rate higher than the real interest rate or inflation has to exceed expected inflation.

The condition whereby inflation exceeds expected inflation is a corollary to Eisner's view that inflation reduces the burden of debt. It also adds some insight to that view. If lenders to the government fully anticipate future inflation, then they insist on interest rates which compensate them for the perspective loss in the purchasing power of debt. On average, say over a period of five years, it is unlikely that lenders will persistently either under- or overestimate the inflation rate. To do otherwise would result in systematic gains and losses on investments and bonds that have not characterized past behavior of the bond market. Eisner's view that there was no real deficit during the Carter years is closely related to the fact that the inflation rate was much higher than the rate that had been anticipated by purchasers of government securities during the late '70s. The reverse has occurred during the 1980s so far. Inflation has been below anticipated levels and so the burden of outstanding debt has risen.

The other way to reduce or stabilize the debt-to-GNP ratio is, not surprisingly, for the economy to grow consistently at a rate above the real interest rate, that is, the interest rate on government securities adjusted for inflation. While that happy outcome is possible for short periods of time, on average the real growth rate usually settles down to a level about equal to the real interest rate. Again, the late 1970s and early 1980s provide a sharp contrast. During the late '70s, real interest rates were low and sometimes negative, largely because lenders failed to anticipate the rapid acceleration of inflation that occurred. As a result any real growth was helpful in reducing the debt-to-GNP ratio. In the early '80s, real interest rates have been at their highest levels in a century and real growth has averaged about two percent. With real interest rates ranging from four to seven percent, the implication has been to contribute to the rapid run-up in the debt-to-GNP ratio.

There is a kind of disquieting self-reinforcing mechanism that can operate if the debt-to-GNP ratio rises for too long. As noted earlier, a rise in the debt-to-GNP ratio, if it is accompanied by a rise in the ratio of private debt to GNP, puts upward pressure on the real interest rate. In turn, upward pressure on the real interest rate puts negative pressure or the real growth rate since it inhibits capital formation. Both of these events tend to reinforce a positive impact on the debt-to-GNP ratio, with the result that a rise in the debt-to-GNP ratio leads to a further rise in the debt-to-GNP ratio through positive pressure on real interest rate and the negative pressure on real growth rates. Such self-reinforcing mechanisms have led to so-called debt crises where the only way out is either to default or, provided that debts are denominated in the currency controlled by the government, to accelerate inflation to a level high above that anticipated by lenders. The latter step of course amounts to a heavy tax on outstanding debt, which leaves past borrowers with heavy losses and current and future borrowers very skeptical about the commitment of the government to price stability. They therefore insist on a higher inflation premium which, if the government tries to regain credibility and actually lower inflation, results in high real interest rates. A mild form of this episode has occurred in the United States during the early 1980s.

By contrast the LDC debt crisis has persisted because developing-country debts are denominated in dollars, not under the control of their own central banks. The inflationary route is therefore not open to the LDCs as they search for ways to reduce the debt burden. They will of course, however, have a strong preference for inflationary policies in the United States which would tend to reduce the real burden of their dollar-denominated debts. Even there, however, the relief LDC debtors can expect from inflation is limited since many of their debts carry floating rates where the interest rate rises with market interest rates, which in turn rise with higher rates of inflation. In sum, the only way out of debt problems for the developing countries is either to grow at remarkable rates well above the real interest rate or simply to default. The outcome is yet to be decided.

Equation (3) suggests some basic guidelines for long-run stability of the debt-to-GNP ratio. Since on average actual and expected inflation rates will be approximately equal over a period of five years, as will real growth and real interest rates, a viable long-run target consistent with a stable ratio of debt to GNP would be to set the primary deficit equal to zero. That would mean keeping the ordinary deficit measure now reported by CBO and OMB equal to interest payments on federal debt. Satisfaction of this condition would not guarantee a stable debt-to-GNP ratio on a year-by-year basis because there would be deviations of growth from the real interest rate and of actual from expected inflation from time to time. Such deviations would likely diminish over time given a stable fiscal policy aimed at a stable debt-to-GNP ratio.

Some perspective can be gained by a look at actual conditions foreseen for the primary deficit. Based on CBO's February 1985 Outlook, which does not incorporate the 1985 budget resolutions for 1986 and beyond, the primary deficit averages 3.4 percent of debt over the five years from 1986 through 1990. That means that on average, stabilizing the debt-to-GNP ratio would require a real growth rate 3.4 percent above the real interest rate, provided that actual and anticipated inflation on average remain equal. Taking the real interest rate to be 3 to 4 percent, the requirement for a real growth rate between 6.3 and 7.3 percent over the remainder of a decade seems optimistic, particularly in view of the approximately 2 percent real growth rate for the first half of the decade.

One may argue that it is too stringent to take the February 1985 CBO baseline, but in view of the slippage surrounding Congressional resolve to cut spending as well as the slippage from the assumed growth rates of 3.5 to 4 percent implicit in the CBO baseline, its use as a prudent planning defice is defensible. The worst that could happen would be that we would exceed the target of stabilizing debt to GNP. There probably would be little harm in that.

The primary deficit implied by the CBO baseline together with a real growth rate close to the real interest rate leaves only one way to stabilize the debt-to-GNP ratio. The Federal Reserve, having gained considerable credibility over the past five years with regard to its inflation-fighting resolve, could accelerate inflation to levels on average 3 to 3.5 percent above expected levels. Such a policy would not be sustainable over much longer than a year since investors, having been burned in the late 1970s, would adjust a good deal more quickly to a more inflationary environment. I would only observe that early in 1986 we are finishing a year of approximately 12 percent money growth, a depreciating currency, and rising wholesale prices. Notwithstanding the apparent desire and tendency to belittle inflationary fears at this point, a creature from outer space looking at the symptoms might begin to get suspicious. I would add that a gold standard, with the price of gold set sufficiently high to license rapid money growth by the central bank, would be another way to devise an inflationary episode that would reduce the debt-to-GNP ratio.

This discussion has identified ways to stabilize the ratio of debt to GNP. Two of them are good and one is bad. The good ways include either cutting government spending or following policies that nurture real growth rates in excess of the real interest rate. I have purposely omitted increasing revenues from the litany of good ways because, although mechanically such an approach would achieve the target, as I have noted under our current tax system, raising taxes magnifies a huge collection of distortions and a cost of the economy of raising another in revenue lies in the $1.40 to $1.50 range. Further, the other good way, that is, engineering growth consistently above the real interest rate, is not something to count on. Such conditions did prevail in the United States in the 1950s and 1960s and have for a time prevailed in other countries both in the developed and the developing world. But for a mature economy, such as that in the United States, the long-run "steady state" is likely to settle at a point where at best real growth equals the real interest rate.

The bad way to lower the debt-to-GNP ratio is to pursue policies which result in inflation above levels anticipated by investors in government securities. This becomes a costly policy when the higher interest rates that result from higher inflation catch up and for a time exceed levels necessary to compensate lenders for losses resulting from the inflationary tax on their accumulated claims on the government. If anything, the lesson of the last decade ought to have made clear the futility of the expedient of inflationary policies to reduce the burden of government debt.

VII. International Policy Considerations

In the light of post-war experience with fixed and floating exchange rates and the need, if not the ability, to coordinate macro economic policy among major economies, it would be a serious error not to consider the international implications of a policy of stabilizing debt to GNP over a period of 5 to 6 years.

First, with fiscal policy set on a rigid, less expansionary path, the remaining degree of freedom to coordinate policy would fall to the monetary authority. A tighter fiscal policy, such as would be implied by conditions required to achieve a stable debt-to-GNP ratio short of inflation or miracle growth, should result in gradually declining real interest rates and continued depreciation of the dollar, barring major policy changes abroad. The trading advantage implicit in a strong dollar enjoyed by America's trading partners would erode, and it is worth considering how they might respond. Were countries in the industrial world to try to preserve their competitive edge, provided that U.S. monetary policy remains aimed at stable or falling inflation, they would pursue more expansionary monetary policies to attempt to redepreciate their currencies against the dollar. As a result, there arises the possibility that at some time during the next half decade, the United States will face a double temptation to follow inflationary policies. One part of the temptation will be the already noted inflationary tax on outstanding debt. The other will be the desire to maintain or restore a competitive advantage that comes from currency depreciation which in turn results from faster money growth. Such a temptation should be avoided since ultimately a global monetary expansion would risk a return to the destabilizing conditions of the late 1970s where monetary assets were dumped and the rush for commodities led to the excesses that resulted in the debt crisis, the failure of many American banks heavily involved in energy loans, and extreme difficulties in the S&L and agriculture sectors today.

This all reveals a very basic point about inflation. Unless there is a willingness to keep accelerating inflation and move on to the hyperinflationary chaos that characterized the Weimar Republic after World War I or Latin American economies in the early 1980s, there are really no net benefits from starting down the inflationary road. Therefore, it is worthwhile to anticipate the conditions under which inflationary policies may seem expendient and try to devise alternative policies that will reduce the temptation to resort to such policies.

Gold or commodity standards have often been suggested, but as we saw in 1971, a gold standard which is not binding provides no discipline. Further, restarting a gold standard at a premium price for gold can be very inflationary in itself.

It is also important to recognize that if fiscal policy constrained by the desire to stabilize debt to GNP or achieve some other deficit goal is accompanied by a move toward fixity of exchange rates, then in a formal sense, monetary authorities will have to be essentially passive.

That is, a given set of exchange rates will require distribution of the quantity of monies around the world roughly proportional to real growth rates. Faster growing economies can have faster money growth, and slower growing economies can have slower money growth. The temptation of slow-growing economies to employ faster money growth as a means to stimulate the economy or to relieve the burden of heavy government debts will either require other countries to follow similar policies will require steady depreciation (inflation) of the currencies of the slower-growing economies.

The overall conclusion is that a combination of stringent targets for fiscal policy and exchange rate fixity reduces the discretion of the monetary authority at a time when more discretion may be desired. Exchange rate fixity therefore requires binding constraints on the separate actions of national monetary authorities. The history of international monetary negotiations and arrangements since World War II and in fact during the three centuries when nations have jealously guarded the right to print their own money has been that nation-states simply will not abide by externally imposed constraints on the conduct of monetary policy.

VIII. Concluding Remarks

There are valid differences of opinion among economists about how to measure budget deficits that drive economic policy decisions. There are also widely differing views concerning the question of whether deficits are harmful to the economy and, if so, whether it would be better to reduce them by cutting spending, raising taxes, or both.

My own view is that over the next five years deficits ought to be scaled down, largely by cutting expenditures, to a level consistent with a stable ratio of federal debt to GNP. Over a decade it is probably prudent to move further toward an inflation-adjusted budget measure that is roughly in balance when averaged over the course of a business cycle. I emphasize that prudence, not economic theory, drives this long-run objective. There is no compelling rationale in economic theory to press for a fully balanced budget particularly on a year-by-year basis.

Attainment of a low, stable inflation rate would obviate the major problems resuting from employment of the usual deficit measures as indicators of the stance of fiscal policy. Stemming the rapid run-up over the last five years in the ratio of federal debt to GNP would help to encourage faster capital formation and higher growth while reducing the temptation to follow inflationary policies.

Lastly, if a tax increase is deemed necessary, the current, badly distorted tax system will have to be radically reformed, not simply revised as in the current House Tax Bill. Otherwise we shall impose a tax burden on the economy equal to nearly one and one-half times the revenue generated.

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Mr. **Rowen**. Thank you very much, Dr. Makin.

I'm told that if you in the audience would like to ask a question raise your hand and a member of the committee staff will pick it up from you and if necessary supply a card so you can write the question out.

Our next panelist is Barry Bluestone, who is director of the Social Welfare Research Institute and professor of economics at Boston College.

PRESENTATION OF BARRY BLUESTONE

Mr. **Bluestone**. Thank you, Mr. Rowen.

I am reminded that as a rather cocky graduate student at the University of Michigan many years ago I once muttered under my breath that I wish I could some day sit in Paul McCracken's seat and make economic policy. I have not a chance to make economic policy yet, but I finally got my chance to sit in his chair. [Laughter.]

I wish to convey today some new findings from a model which the U.S. Congress has been supporting, the multiregional policy impact simulation model, and then suggest from those findings that there are lessons for deficit reduction. Three of these lessons are for the Members of Congress in this room and one is for Mr. Volcker.

Before coming here today, I checked the history books and found that when the Joint Economic Committee was established in 1946, the Federal debt of the United States was $271 billion. It was 30 percent greater than the entire gross national product, and despite the end of the war, the Government still ran a $15.9 billion deficit that year, 7.6 percent of gross national product.

Between that year and 1980, the debt grew to $1 trillion. But what is most important is that for most of that period the debt was virtually a constant one-third of annual GNP and net interest payments never exceeded 11 percent of Federal receipts during that entire period of time.

Times have, of course, changed. Between 1982 and 1985 we have accumulated something in the neighborhood of $730 billion of additional deficit spending. What I find most important about this is not the size of the debt per se or the sheer amount of deficit spending, but the fact that debt service has risen from 10.2 percent of total Federal receipts in 1980 to a present 18 percent. Put differently, we are now spending approximately $2 out of every $5 in personal income tax receipts simply to pay interest on the debt whereas we spent only $1 out of $5, 5 years ago. While in 1980 we spent 76 percent of corporate income tax receipts to service the debt, this year we will spend on net interest twice as much as we receive from this particular tax. The problem, therefore, is finding the resources to finance the interest on the debt.

The response to all of this was the passage of the Gramm-Rudman bill. Despite my great admiration for both of those gentlemen, I understand that in Washington they are now referring to this legislation as the Gramm-Rambo bill of 1985. Indeed, I think it does run the risk of being the most important piece of social legislation since the Smoot-Hawley tariff in 1929 or, as Senator Rudman himself put it, "this is a bad idea whose time has come."

How we deal with the debt is going to make a major difference in every single economic indicator in the economy. The multiregional policy impact simulation model provides us some indication of not only how deficit reduction might be achieved, but how deficit creation has actually occurred and what its social and economic impacts have been.

Based on a study completed by the Congressional Budget Office a little over a year ago which looked at how the deficit was generated between 1981 and 1985, CBO arrived at the conclusion that Government spending on defense had increased by about $35 billion over what it would have been under 1981 fiscal policy priorities, nondefense discretionary spending had been cut by about $16 billion, and entitlement programs relative to the 1981 priorities had been cut by roughly $30 billion.

On top of that, of course, we had a series of tax cuts, which included a cut of $124 billion in personal income taxes offset by $19 billion in increased Social Security revenue.

By anybody's crystal ball—and you don't have to be a member of the occult to see it—this type of fiscal policy should be enormously expansionary. According to our model, it was.

If we look just at the Government policies themselves, abstracting from other changes in the economy in the private sector, the deficit-creating set of fiscal policies first enacted in 1982 added $121 billion to gross national product in calendar year 1985 and added about 3.4 million new jobs to the American economy. This left the national unemployment rate closer to 7 percent than the 9 percent it would have been if we had maintained 1981 fiscal policy priorities.

Real disposable income rose by 7 percent as a result of those fiscal policy changes. Family disposable income went up by over $157 billion. Wages and salary gains measured almost $69 billion. AFDC and food stamp program expenditures as a result of expansion in the economy were reduced by about $5 billion and we saved another $8.1 billion in unemployment insurance as a result of declining joblessness.

This was the good news. There is, however, a dark side to this particular set of policies, and the dark side has to do with the income distribution effects of this particular set of fiscal policy priorities.

According to the analysis in our model, the bottom one-tenth of all families in the country actually lost an average of 2.1 percent in family disposable income, despite the fact that this was the most expansionary set of policies in the history of the country.

On the other hand, the top 20 percent of all families, the wealthiest 20 percent, gained on average as a direct result of these policies some 10 percent in family disposable income and indeed when you look at all the numbers, it turns out that 96 percent of total income gains went to the top 55 percent of the population. Roughly speaking, the bottom half of the population received less than 5 percent of the total gain from this set of policies.

The impact on poverty followed along these lines. While 413,000 families were able to move above the poverty line, more than a million other families were forced below, leaving 636,000 additional families impoverished.

And the inequities were not only by family income class. They were also by region. The Northeast and the Pacific region did quite well, especially due to increased defense spending. The Farm Belt and parts of the Midwest were hurt very badly.

We ran a second simulation, through the model. We asked what would happen if we had a radical restructuring of Federal spending policy; what would happen if peace broke out as a result of the Reagan-Gorbachev meetings and we could cut defense spending by $35 billion in 1986 and, instead, use that money for a set of what we call physical and human capital infrastructure development—major highway construction, public utilities, nonresidential construction, education, health, and social services. We even threw in another 5 percent for NASA so we could explore the universe.

The result of that policy is quite salutary. It turns out that that transfer of funds which leaves an ex-ante-change in the budget balance of zero—$35 billion out of defense; $35 billion into these other programs—actually adds $5.4 billion to gross national product and 262,000 new jobs. Moreover it actually increases income tax receipts by about $3 billion.

What are the lessons to be learned from this? I would argue there are five lessons. One, how we spend our money matters. The specific tax transfer and expenditure tools used in the course of creating a debt or conversely reducing a deficit can have dramatically different consequences for various income classes and regions.

Lesson 2, the tax, transfer, and expenditure policies adopted since 1981 have led to a significant increase in income inequality.

No. 3, in order not to further exacerbate inequality during the Gramm-Rudman-Hollings deficit reduction era, it will be necessary to pay careful attention to what precise measures are used for this purpose.

No. 4, we need a careful retargeting of Federal spending patterns.

Five, it is indeed possible to have Federal deficit reduction without further increasing income inequality.

These are four steps that we should take toward deficit reduction. No. 1, we should redistribute Federal spending priorities toward infrastructure development.

No. 2, to attack the most serious problem of accumulated national debt—the interest payments on it—we should expand the money supply so as to reduce interest rates.

No. 3, we are going to have to have a tax increase. I suggest a vanishing tax surcharge which could be placed on top of a tax reform measure of either the Treasury II or Rostenkowski variety. The surtax would be set so as to vanish as we move toward a reasonable deficit reduction target.

Finally, No. 4, only as a very last resort should we further cut civilian spending. After more than half a decade of Government-induced increased inequality, using deficit reduction as a club to further bludgeon the poorer half of American society would be cruel and indeed needless. Thank you.

[The complete presentation of Mr. Bluestone follows:]

REDUCING THE FEDERAL DEFICIT FAIR AND SQUARE

Barry Bluestone
John Havens

ABSTRACT

Since 1982, the federal government has been responsible for more than $730 billion of deficit spending. As a consequence, it now requires nearly two-fifths of total personal income tax revenue simply to pay the annual interest on the national debt whereas it took little more than one-fifth at the beginning of the decade. The response to this debt explosion has been the Gramm-Rudman-Hollings deficit reduction act, an attempt to sharply reduce government spending over the next five years.

Relying on two simulations generated with the new Multi-Regional Policy Impact Simulation (MRPIS) model developed at the Social Welfare Research Institute at Boston College, this paper investigates the aggregate economic effects and the distributional consequences of deficit creation and deficit reduction. Simulation #1 demonstrates that the tax and expenditure policies instituted by the federal government after 1981 played an important role in bringing about economic recovery, but the nature of the tax/transfer/expenditure package used to achieve this result drastically increased income inequality, led to substantial regional disparities, and pushed more than 630,000 families into poverty.

Simulation #2 evaluates a hypothetical shift in federal spending from defense to domestic infrastructure development (both physical and human capital). The results suggest that a $35 billion transfer of funds would generate more than $5 billion in additional GNP and more than 250,000 new jobs while reducing deficits and not increasing income or regional inequality.

These two simulations provide five important lessons about deficit reduction:

(1) The specific tax, transfer, and expenditure tools used in the course of creating (or conversely, reducing) a deficit can have dramatically different consequences for various income classes and regions.

(2) The tax, transfer, and expenditure policies adopted since 1981 have led to a significant increase in income inequality.

(3) In order not to further exacerbate inequality during the Gramm-Rudman Hollings deficit reduction era, it will be necessary to pay careful attention to what precise measures are used for this purpose.

(4) Careful retargeting of federal spending patterns can result in economic growth plus ex post deficit reduction without cutting -- and indeed expanding -- needed civilian spending.

(5) Deficit reduction need not have the effect of further increasing income inequality.

To accomplish efficient and equitable deficit reduction, it is necessary to approach the problem in stages using the least invasive methods of remedy first.

Step 1 Redistribute federal spending priorities toward infrastructure development to hold the line on the deficit and begin its reduction.

Step 2 To attack the most serious problem with the accumulated national debt -- the rise in the proportion of tax dollars used to service the debt -- the government should rely on monetary expansion to drive down interest rates, especially in this period of low rates of core inflation.

Step 3 To further reduce the deficit, the Congress should pass a compromise version of the generally progressive Treasury II and Rostenkowski tax bills and then add a "vanishing surtax" to the new lower personal income tax rate structure. The tax surcharge rate would be reduced as deficits shrink and would ultimately be phased out.

Step 4 Only as a very last resort should the government use further civilian program cuts to curtail the deficit. After more than half a decade of government-induced increased inequality, using deficit reduction as the club to further bludgeon the poorer half of American society would be a cruel and indeed needless act.

REDUCING THE FEDERAL DEFICIT FAIR AND SQUARE

Barry Bluestone
John Havens
Boston College[1]

Forty years ago, as the Joint Economic Committee was being established, the federal debt stood at $271 billion. Swollen by the unprecedented spending of World War II, the debt in 1946 was nearly thirty percent larger than the gross national product. Despite the end of the war, the government still ran a $15.9 billion deficit that year, an amount equal to 7.6 percent of GNP. In the course of the next thirty-five years, the dollar value of the debt would rise to one trillion dollars (FY1981). But with rapid economic growth, it settled down in relative size to little more than one-third of annual

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[1] Barry Bluestone is Professor of Economics and a Senior Research Associate, Social Welfare Research Institute (SWRI), Boston College. John Havens is a Senior Research Associate at SWRI. The authors are co-directors of the Multi-Regional Policy Impact Simulation (MRPIS) project. The MRPIS model, which provides the simulations reported here, has been developed by senior staff at SWRI including Lynn Ware, Alan Clayton-Matthews, Carol Pepin, Steven Fournier, and Peter Jordan. The MRPIS project is funded by the Assistant Secretary for Planning and Evaluation of the U.S. Department of Health and Human Services.

GNP. For nearly two generations, paying for the debt was relatively easy in as much as net interest payments never exceeded 11 percent of total federal government revenues until 1981.[2]

The relative ease with which debt finance could be accomplished came to an end around 1982. With more than $730 billion of deficit spending since then, the debt as a percentage of GNP has risen sharply. In 1985 the ratio reached 47 percent.[3] More importantly, in just five years debt service has risen from 10.2 percent of total federal receipts to more than 18 percent. It now requires nearly two-fifths of total personal income tax revenue simply to pay the annual interest on the debt whereas it took little more than one-fifth at the beginning of the decade. Alternatively, debt service now claims more than twice the revenue generated by the corporate income tax.

The shock waves emanating from this unprecedented explosion of government red ink was directly responsible for the Gramm-Rudman-Hollings deficit reduction act. In terms of potential economic ramifications, this bill has no rival save perhaps the infamous Smoot-Hawley tariff of 1929. Gramm-Rudman mandates drastic cuts in the federal budget with the explicit purpose of reducing a string of $200 billion deficits to zero by 1991. How this Herculean task will be accomplished over the course of the next five years will ultimately affect every single measure of the economy. The rate of economic growth, the size of the trade deficit, the level of employment, and -- as we shall argue -- the distribution of income will all be profoundly affected depending on how this legislation is actually implemented.

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[2] Calculated from Council of Economic Advisers, Economic Report of the President, 1985 (Washington D.C.: Government Printing Office, 1983) Table B-73, p. 248 and Table B-1, p. 163.

[3] Calculations based on U.S. Congress, Joint Economic Committee, "Economic Indicators", October 1985 (Washington D.C.: Government Printing Office, 1985) p.32.

There are a slew of questions about federal deficits that ultimately need answers. Mere measurement of the deficit remains problematic in itself.[4] Even more critical is the lack of consensus about the potential economic consequences of deficit finance. The links between deficits and interest rates, between budget deficits and trade deficits, and between deficits and inflation are not at all well understood. Yet, despite the sorry state of economic science in these realms, this paper will not attempt to address any of these issues directly. Rather it shall address an equally critical question of economic policy: how does the creation of a deficit or its opposite, deficit reduction, affect the distribution of income in the nation? We believe that a reasonable answer to this question can be of significant value in providing lessons on how to reduce federal deficits in an efficient and equitable manner.

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[4] For a discussion of measurement problems associated with the federal debt and budget deficits, see Robert Eisner and Paul J. Pieper, "A New View of the Federal Debt and Budget Deficits," American Economic Review, Vol. 74, No. 1, March 1984, p. 11-29, and Michael J. Boskin, "Federal Government Deficits: Some Myths and Realities," American Economic Review, Vol. 72, No. 2, May 1982, p. 296-303. The absense of a capital budget in the federal accounting system leaves a false impression of the net worth of the public fisc. Ignoring fluctuating interest rates and the effects of inflation in the reporting of deficit figures may confuse the actual surplus/deficit position of the government.

Simulating Deficit Creation and Reduction

There was never any doubt (except in the fantasies of a few stalwart supply-siders) that the combination of tax, transfer, and expenditure policies put in place from 1981 onward would generate massive deficits. What was not entirely known was how these would affect the economy. To trace these effects with the benefit of hindsight, we rely on two policy simulations undertaken at the Social Welfare Research Institute utilizing the Multi-Regional Policy Impact Simulation model (MRPIS Level 2.0).

From its initial conception in 1980, the MRPIS model was developed with the explicit purpose of providing information about the aggregate economic impacts and the distributional consequences of a broad array of government tax, transfer, and expenditure policies.[5] Relying on a circular flow model of the economy with both household and industry sectors linked by product and labor markets, the MRPIS model is capable of measuring the impact of policy changes on individual regions, industries, occupations, and socio-demographic groups. The model uses microdata household simulation, multiregional input-output analysis, and simulations of consumer and labor market demand. As a complement to macro econometric models, MRPIS provides rich detail on the output, employment, and family income consequences of various government policies.

Two simulations will be examined here. In the first, we compare the economic effects of the revenue and expenditure priorities in the FY1981 budget with those inherent in the FY1985 budget. Essentially, this reveals the consequences of recent deficit creation. The second simulation analyzes a "counterfactual" budget in which dollars are shifted from one set of federal programs to another in order to demonstrate how federal budget priorities affect economic activity and the overall size of deficits. The results of these two simulations provide some important lessons on the distributional impacts of running deficits and simultaneously produce guidelines on how to effectively reduce them.[6]

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[5] For basic information about the MRPIS model, see "Overview: MRPIS Level 2.0 Model," Social Welfare Research Institute, Boston College, November 1985.

Simulation #1:FY1981 vs. FY1985 Budget Priorities

As noted above, since 1981 the federal government has been responsible for more than $730 billion of deficit spending. The creation of this additional debt has had a profound impact on virtually all aspects of the economy. In response to a request from the Senate and House Budget Committees, the Congressional Budget Office (CBO) early last year prepared a set of statistics on the tax and expenditure sources of the increased federal deficit between FY1981 and FY1985.[7] MRPIS Simulation #1 is based on the CBO report that includes these numbers.

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[6] The two simulations are confined to the immediate fiscal impacts of federal tax, transfer, and expenditure policies. Important economic phenomena such as those emanating from the money market, the trade deficit, exogenous capital formation, and the changing exchange value of the dollar are not included in either simulation. Hence, the simulations identify the explicit economic impacts of new policy initiatives independent of all other factors.

[7] See Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1986-1990, A Report to the Senate and House Committees on the Budget - Part I, Appendix D, "Changes in Budgetary Policies since January 1981," February 1985.

To produce the initial estimates for the Congressional Budget Committees, CBO first forecast what tax revenues and federal spending on procurement and entitlement programs would have been if the tax policies and expenditure priorities of the FY1981 budget had been carried forward to future years without alteration. These "counterfactual" estimates were then compared with actual FY1985 tax and expenditure levels by revenue source and expenditure category. The "line item" differences between 1981 and 1985 budgets were then used as input for MRPIS Simulation #1.

The MRPIS model generates estimates of output, value-added, and employment by industry and region (state) and estimates the impact of these changing budget priorities on individual earnings, family disposable income, transfer payments, and tax liabilities across regions and an array of socio-economic groups. Thus, the distribution of gains and losses associated with changes in tax code and federal spending priorities is revealed, in addition to the aggregate impact on output and employment. Given the nature of the new tax and expenditure priorities, the results essentially identify the various effects of the deficit creation policies put in place beginning in 1981.

Simulation #1 Assumptions

According to the CBO analysis, legislated expenditure changes since 1981 have had the following effect on the FY1985 unified budget:

	$ billions
Defense spending increases	+ 35.0
Non-defense discretionary cuts	- 16.0
Entitlement program cuts	- 29.9

In addition, using the MRPIS federal income tax simulator, the following changes in tax revenues were estimated:[8]

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[8] The CBO had slightly different estimates of tax revenue changes from those generated by the MRPIS federal tax simulator. While there is virtually no difference in total revenue loss estimates, there is a small variance in the sources of the revenue decline. CBO estimates a somewhat smaller personal income tax decline while MRPIS estimates a somewhat larger increase in FICA taxes.

	CBO Estimate	MRPIS Estimate
Personal income tax	- $117 b.	- $124 b.
FICA tax	+ 11	+ 19
Net Change	- $106 b.	- $105 b.

Presumably, these revenue estimates vary slightly from each other because of differences in the underlying data bases and in assumptions regarding income growth rates, inflation rates, and in the precise methods of calculation. CBO also apparently attributed future increases in FICA taxes to FY1981 policy, while MRPIS treated all changes in FICA rates after 1981 as post-1981 policy revisions.

	$ billions
Personal income tax revenues	-124.0
Social Security tax revenues	+ 19.0

Essentially, defense spending is $35 billion higher in 1985 under the FY1985 budget than it would have been if the defense priorities of the FY1981 budget were in effect. Conversely, non-defense procurement was down by $16 billion while entitlement and other mandatory programs were reduced by close to $30 billion.[9] On the revenue side, the combination of the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Social Security Amendments of 1983 reduced personal income tax liabilities by $124 billion, but increased FICA taxes by $19 billion.[10]

Simulating the impacts of these macroeconomic changes at a disaggregated level requires the proper apportionment of spending changes at the appropriate level of detail for the model. DOD and non-DOD procurement shifts must be made both industry and region specific, and overall entitlement changes must be charged to the correct source. These tasks were accomplished using a variety of data sources including the Survey of Current Business, the detailed agency breakdown in the FY1986 Federal Budget, federal final government demand data in the 1977 Multi-Regional Input-Output (MRIO) model, and unpublished CBO data on changes in individual entitlement programs. The changes in entitlements were proportionally allocated to individuals on the MRPIS micro data file based on the amount of entitlements received by each family according to the Current Population Survey for March 1983.[11,12]

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[9] The largest entitlement cuts were in Social Security benefits ($9.1 b.), farm price supports ($4.2 b.), and Food Stamps and child nutrition programs ($3.3 b.).

[10] In addition to these three legislated tax changes, there were smaller revenue effects from the Surface Transportation Assistance Act of 1982, the repeal of withholding of tax from interest and dividends, and the Deficit Reduction Act of 1984. These, along with the $12 billion cut in the corporation income tax and the offsetting $12 billion increase in excise taxes were not analyzed in this simulation.

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[11] For additional detail on this simulation, particularly its assumptions, see John Havens, Barry Bluestone, Stephen Fournier, and Carol Pepin, "The Microeconomic Impacts of Macroeconomic Fiscal Policy 1981-1985," MRPIS Project, Social Welfare Research Institute, Boston College (Draft Report) November 8, 1985.

[12] In addition to these policy assumptions, it was necessary to make a number of economic and population growth assumptions to carry out this simulation. The MRPIS Level 2.0 model relies on the 1983 Current Population Survey Annual Demographic File to simulate households behavior. This file provides detailed information on a large sample of households, families, and persons for calender 1982. To adjust data on the file to better reflect current (1985) incomes and the number of current households, the 1983 CPS was reweighted to take into account inflation and household formation. Based on Survey of Current Business data, all 1982 incomes were increased by 11.61 percent, representing the compound Consumer Price Index (CPI) inflation rate between 1982 and July 1985. Real growth in income was incorporated by increasing sample record incomes by 8.4 percent. This number is based on actual per capita income growth of 10.9 percent between 1982 and July 1985 deflated by an average MRPIS multiplier of 1.3. Similarly, sample weights were multiplied by a factor of 1.042, representing 4.2 percent population growth.

The Results - Simulation #1

Primarily as a consequence of the enormous tax cuts since 1981, the government's fiscal policy should have been highly expansionary. Indeed, it was, confirming the effectiveness of old-fashioned Keynesian demand-side stimulus. Analysis of the results from simulation #1 indicates that the nation's GNP was $121 billion higher in 1985 under the FY1985 fiscal priorities than it would have been if 1981 tax and spending patterns had remained in effect. Total output across all industries was up by $252.8 billion resulting in the creation of 3.4 million additional jobs.[13]

By any standard, these are not trivial effects. Evaluated in the second quarter of 1985 (1985:II), GNP was 3.1 percent higher than it would have been under 1981 policies. Without the new expansionary program, the unemployment rate would have been close to 9.0 percent in 1985 rather than the

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[13] The MRPIS 2.0 model provides estimates of the initial output of goods and services generated by the original change in taxes and expenditures. This initial amount was $186.2 billion. In subsequent spending rounds, $66.7 billion of additional (induced) output was generated producing the $252.8 billion total. The ratio of total to initial output provides an estimate of the short-run MRPIS output multiplier: 1.36. The initial change in output required the employment of 2.5 million persons. Induced output generated more than 900,000 more jobs bringing the estimated total to 3.4 million.

7.3 percent actually achieved.[14] Indeed, by these calculations, approximately half of all the job growth since 1981 can be attributed to the direct or indirect effect of these fiscal policy initiatives.

Table 1 shows how the expansion affected family income, earnings, tax revenues, and transfer payments.

Table 1

Simulation #1 Results

Income, Taxes, and Transfers
($1985 billions)

Component	Baseline Value	Total Change	Percent Change
FAMILY DISPOSABLE INCOME	$2,240.3	$157.6	7.03%
WAGES AND SALARIES	1,814.2	68.9	3.80
FEDERAL PERSONAL INCOME TAX	462.5	-124.4	-26.91
STATE INCOME TAX	57.9	4.3	7.34
FICA TAX	104.1	19.3	18.51
AID TO FAMILIES WITH DEPENDENT CHILDREN	11.1	-1.3	-12.18
FOODSTAMPS	17.1	-3.8	-22.36
UNEMPLOYMENT INSURANCE BENEFITS	31.8	-8.1	-25.24

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[14] This unemployment rate estimate is based on the assumption that half of the new jobs created went to officially unemployed workers while half went to those who were out of the labor force -- perhaps "discouraged workers". Instead of the actual 8.5 million unemployed in 1985, the simulation suggests that 1981 policies may have left 10.2 million unemployed and as many as 1.7 million additional discouraged workers.

Some of the major highlights are:

- Family disposable income is $157.6 billion higher under the FY1985 budget and tax priorities. This represents 7 percent more disposable income than under FY1981 policy assumptions.

- Part of this gain in disposable income is due to additional wage and salary earnings amounting to $68.9 billion. This represents a 3.8 percent boost in earnings.

- The combined set of personal income tax cuts between 1981 and 1985 resulted in 27 percent less personal income tax revenue despite the expansion in the economy.

- Cuts in the AFDC and Food Stamp programs, along with the expansion of the economy, contributed to a $5 billion "savings" to the government.

- The dramatic increase in employment reduced unemployment insurance benefit payments by a healthy $8.1 billion.

This was the good news. But there was also a less sanguine side to the new policies. As a package, deficit creation in the early 1980s, given the method by which it was carried out, not only left the nation with a "debt problem" but also generated sharply increased income inequalities. Those already at the top of the income distribution received disproportionately large gains from the tax and budget shifts, while those at the bottom either benefitted little, or, in many cases, sustained outright income losses.

The most comprehensive measure of these distribution changes can be found in the changes in family disposable income by income class.[15]

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[15] For purposes of this analysis, Current Population Survey defined "unrelated individuals" are counted as individual family units.

Table 2

Changes in Family Disposable Income due to
FY1982-1985 Fiscal Policy Priorities
($1985 dollars)

Income Class	% of all families	Percent Change in Disposable Income
$ 0- 5500	9.1%	-2.13%
5501- 8500	8.6	-0.97
8501-11250	8.9	1.08
11251-14000	9.3	2.23
14001-16750	8.6	3.49
16751-33500	36.0	6.09
33501-	19.5	10.05
ALL CLASSES	100.0%	7.03%

The average family in the top income category saw its disposable income rise by more than 10 percent while those in the lowest income group sustained a 2 percent loss. Cumulatively, more than 63 percent of the total increase in disposable income ($99.7 billion out of the $157 billion generated) accrued to the top 19.5 percent of all families. This represents an enormous shift in income even when compared with the 44 percent initial income share accruing to this group which contains less than one-fifth of the population. The deficit creating policies of 1982-1985 increased the average disposable income of these high-income families by more than $5,300 each (in 1985), an increase of more than 10 percent over the $53,000 annual average earned under FY1981 spending and tax priorities. Moreover, the top two income categories containing just over half (55.5%) of the population received more than 96 percent of all the newly generated disposable income. Meanwhile, at the other end of the distribution, the lowest income families actually lost disposable income primarily as a consequence of transfer program spending cuts. Families with income of $5500 or less averaged a $67 loss equivalent to more than 2.1 percent of their pre-policy change income. (See Table 3 for a detailed breakdown of these numbers.)

The tendency of these tax and spending policies to create substantially greater inequality -- for the "rich to get richer while the poor get poorer" -- is confirmed by estimated Gini coefficients for the initial and post-policy income distributions. Under the FY1981 policy regime, the Gini equalled .3693. Under the new policy regime, the Gini rose to .3833 indicating a significant increase in inequality.[16]

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[16] Small changes in the Gini index of inequality represent rather large changes in the income distribution. Consider the fact that the Gini for the distribution of family money income had a total range of .348 to .381 between 1947 and 1982, despite all of the changes in policy over that thirty-five year period. See U.S. Department of Commerce, Bureau of the Census, Money Income of Households, Families, and Persons in the United States: 1982, Consumer Income, Series P-60, No. 142, Table 17, p. 47.

Table 3

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MRPIS POST PROCESSOR     MRPIS 022F1/UT1 +0358 DEF -0160 NDEFP -0200 FNT E '81-'85 TAX 1.0008 GRW 19858       851016        PAGE 338

                                          AGGREGATE CHANGES IN FAMILY DISPOSABLE INCOME
                                                  (MILLIONS OF DOLLARS)

REGION                       <=5500   5501-8500  8501-11250 11251-14000 14001-18750 18751-33500 33501+           TOTAL         GINI


32 NATIONAL TOTAL

    BASE-'81 POLICY      27719.799   57444.916   84246.918  112369.012  126898.162  838055.037  991616.987 2240943.031  0.36933038
    # OF FAMILIES          8730142     8220727     8554608     8914105     8258567    34609657    18690536    96000339
    % OF FAMILIES             9.12        8.56        8.91        9.28        8.60       36.05       19.47      100.00
       MEAN                   3165        6988        9848       12606       15365       24212       53056       23339
       PERCENT                1.24        2.56        3.76        5.02        5.66       37.40       44.26      100.00

         INITIAL         -1189.340   -1170.521    -165.199     946.678    2381.741   34874.544   78391.213  114069.114
         INDUCED           598.786     614.506    1072.697    1556.233    2042.842   16295.382   21305.747   43486.192
         CUM TOT          -590.555    -556.016     907.498    2502.910    4424.583   51169.926   99696.960  157555.307
         MEAN CH               -67         -68         106         281         536        1478        5334        1641
         % BASEY             -2.13       -0.97        1.08        2.23        3.49        6.09       10.05        7.03
         PERCENT             -0.37       -0.35        0.58        1.59        2.81       32.48       63.28      100.00

    '85 POLICY           27129.244   56888.500   85154.416  114871.922  131314.745  889225.363 1091313.947 2397898.338  0.36332024
       MEAN                   3098        6920        9954       12887       15900       25691       58389       24976
       % BASEY               97.87       99.03      101.08      102.23      103.49      106.09      110.05      107.03
       PERCENT                1.13        2.37        3.55        4.79        5.48       37.17       45.51      100.00
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At the very low end of the income distribution, we can find the most disturbing news of all. While 413,000 families initially below the official poverty line rose above it by reason of the new tax and spending policies, at the very same time more than 1 million previously non-poor families were forced below the poverty line as a direct consequence of the deficit creating policies. This net increase of 636,000 poor families led to an increase in the proportion of American families in poverty from 13.5 percent under the 1981 policy regime to 14.1 percent under the new one. Adding insult to injury, those families that were originally below the poverty line (and remained below) actually suffered a further 3.4 percent erosion in their already depressingly low disposable incomes. Again, this all occurred despite the fact that the government was pumping up the economy with hundreds of billions of dollars of deficit spending.

This particular pattern of deficit spending also created substantial regional inequities. The New England and Pacific Census regions both averaged 8.2 percent gains in family disposable income, nearly sixty percent higher than those experienced in the West North Central farm belt. Increased defense procurement is the overwhelming reason for the East and West Coast gains while relative cuts in farm support programs are responsible for the mediocre income performance in the Midwest. Indeed, farm families were adversely affected by more than just declining world grain prices. Revisions in federal farm programs from 1982 on left the average farm family with .5 percent less disposable income compared to the 7 percent gain for all families.

Simulation #1 thus provides a number of lessons for the period of deficit reduction just ahead.

Lesson 1	The specific tax, transfer, and expenditure tools used in the course of creating (or, conversely, reducing) a deficit can have dramatically different consequences for various income classes and regions.
Lesson 2	The tax, transfer, and expenditure policies adopted since 1981 have led to a significant increase in income inequality.
Lesson 3	In order not to further exacerbate inequality during the Gramm-Rudman-Hollings deficit reduction era, it will be necessary to pay careful attention to precisely which government programs suffer substantial budget reductions.

Simulation #2: A "Rebuild America" Scenario

There are even more compelling lessons to be learned from simulating other possible fiscal policies. To investigate these, we prepared a second MRPIS run to demonstrate the economic effects of simply shifting government spending patterns without changing overall ex ante expenditure levels. In simulation #2, we have posited a decrease of $35 billion in defense procurement. This can reasonably be thought of as the mirror image of the FY1981-FY1985 growth in DOD spending determined by the CBO and analyzed in simulation #1.[17]

To achieve an ex ante balanced budget, $35 billion of federal spending was then allocated to non-defense areas of the budget. As reflected in the title of this simulation, we chose to allocate funds for rebuilding the "infrastructure" of the nation. In this case, we have used the term infrastructure liberally, to cover not only the physical

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[17] The $35 billion decrease in defense procurement is apportioned across eighty input-output category industries according to the actual 1977 distribution of DOD spending adjusted by FY1985 budgeted spending patterns. More than 75 percent of the $35 billion is accounted for in just twelve of the eighty industries.

Top 12 DOD Industries

Industry	Simulated Change in Spending
(1) Communications equipment	$6.938 b.
(2) Aircraft frames and parts	4.503
(3) Other transport equip. (ships)	3.508
(4) Aircraft/missile engines	2.693
(5) Misc. services (e.g. R&D)	2.266
(6) Air transportation	1.541
(7) Petroleum refining	1.289
(8) Ordnance	1.259
(9) Office & computing equip.	.782
(10) Maintenance construction	.557
(11) Scientific equipment	.528
(12) Electric lighting/wiring equip.	.525
TOP 12 INDUSTRIES	$26.389
TOTAL	$35.000

aspects of capital that make the operation of an industrial society possible (i.e. the system of roads, bridges, utilities, etc.) but to cover "human capital" as well. Essentially, we chose to simulate the effects of shoring up both the capital and labor inputs of the economy.

As shown below, physical and human capital received 95 percent of the total federal funds invested in our "rebuild America" scenario. Because the cuts in defense expenditure would be most seriously felt in the aerospace industry, we targetted 5 percent of the "rebuild" budget toward that sector in the form of increases in NASA related activities. The final categorical breakdown for simulation #2 is found in Table 4.

Table 4

Distribution of "Rebuild America" Expenditures

Sector	Expediture Percentage
Major Construction	30%
-Highways and streets -Public utilities -Non-residential construction -Maintenance construction	
Transportation	15%
-Local transit -Other transportation	
Education	25%
Health Care	15%
Social Services	10%
NASA Related Activities	5%
TOTAL	100%

The actual distribution of expenditures across this target list of sectors resulted in increases in final demand in a total of thirteen different industries.[18] The full set of industries affected by this $35 billion increase in spending is presented in Table 5.

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[18] To complete the simulation, these changes in industry demand required distributing government procurement across the various regions of the country. A variety of measures were used to accomplish this task. For highway and street construction, the actual number of roadway miles in a state was used as the distribution measure. State population was used to distribute other types of construction spending, etc. The actual matrix of final demands generated by industry and state, along with the data sources used in this exercise, are available from the Social Welfare Research Institute.

Table 5

Complete List of Rebuild America Industries

Industry	Total Expenditure (in $1985 billions)
Non-Residential Construction	$ 2.799
Public Utility Construction	2.549
Highways and Streets	2.641
Other Construction	.588
Maintenance Construction	1.924
Communications Equipment	.175
Missiles and Parts	1.576
Other Transportation Equipment	3.500
Local Transit	1.750
Doctors, Dentists	4.937
Other Health Services	.313
Educational Services	8.750
Other Social Services	3.500
Total	$35.000

The Results - Simulation #2

Theoretically, there are at least three possible outcomes for the "Rebuild America" scenario. One is that an ex ante balanced budget shift in spending might have virtually no impact on economic aggregates. Non-defense spending might contribute no more nor no less to GNP, output, and employment than an equivalent dollar amount of DOD procurement. On the other hand, because of differences in wages and salaries per value-added dollar and differences in employment-output ratios between defense and non-defense industries, ex post aggregates could be substantially different.

Indeed, there is a long-standing debate over the relative economic efficiency of defense and non-defense spending. This is particularly true with respect to their employment generating potential. Critics of military spending have frequently argued that it creates fewer jobs than virtually any other form of federal spending, and even that military spending can cost the economy jobs.[19] In contrast, a number of studies -- particularly those undertaken by the DOD itself -- have suggested that defense spending actually creates more jobs per billion dollars of federal outlays than civilian spending.[20] The most comprehensive study of the issue, performed by the Congressional Budget Office in 1983, comes to the more modest conclusion that, in general, where the government spends an additional dollar does not make much of a difference in job creation.[21]

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[19] See for example, Marian Anderson, The Empty Pork Barrel (East Lansing, Mich.: Employment Research Associates, 1982); David Gold, et.al., Misguided Expenditure: An Analyis of the Proposed MX Missile System (New York: Council on Economic Priorities, 1981); Robert Bezdek, "The Econnomic Impact - Regional and Occupational - of Compensated Shifts in Defense Spending," Journal of Regional Science, Vol. 15, No.2 (1975).

[20] See Casper Weinberger, Annual Report to the Congress, Fiscal Year 1984 (Washington, D.C.: Department of Defense, 1983), p. 68.

The "Rebuild America" simulation demonstrates, on the other hand, that while generalized spending on defense may not produce significantly different economic outcomes from generalized non-defense spending, the particular expenditure pattern embodied in rebuilding physical and human capital infrastructure is in fact expansionary in terms of GNP, total output, employment, and family disposable income. As a result, the shift in spending priorities actually reduces the federal deficit while inducing more economic growth.

On net, the $35 billion expenditure shift generates a $5.4 billion boost in GNP on the basis of a $6.4 billion increase in total industrial output. While these additions to GNP and output appear to be rather modest, the impact of the shift in spending on employment is anything but trivial. More than a quarter of a million (262,000) full-time equivalent jobs (FTE's) are created. In turn, the increase in employment is responsible for adding more than $8 billion of wages and salaries to the economy. This finally leads to a boost in personal income tax revenue of $2.5 billion and an additional $300 million in Social Security taxes. Table 6 provides a summary of these results.

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[21] See Congressional Budget Office, Defense Spending and the Economy (Washington, D.C.: CBO, 1983), p. 43. For an excellent discussion of this entire issue, see Gordon Adams and David Gold, "The Economics of Military Spending: Is the Military Dollar Really Different?" (Washington, D.C.: Center on Budget and Policy Priorities - Defense Budget Project, December 1985).

Table 6

Simulation #2 Results
("Rebuild America")

Output, Income, Taxes, and Transfers
($1985 billions)

Component	Total Change
GROSS NATIONAL PRODUCT	$5.4
TOTAL OUTPUT	6.4
EMPLOYMENT GROWTH (FTE's) (in thousands)	261.9
FAMILY DISPOSAL INCOME	5.6
WAGES AND SALARIES	8.0
FEDERAL PERSONAL INCOME TAX	2.5
FICA TAX	.3

Source: MRPIS Simulation, Social Welfare Research Institute, Boston College, November 1985.

Here, then, is an example of deficit reduction (modest, to be sure) consistent with expanding rather than depressing the economy.

The reason why this particular expenditure shift provides such sanguine results is not transparent. It is revealed, however, in an examination of two critical ratios in the two sets of affected industries. Ratio I is industry wages and salaries per dollar of industry value-added. Ratio II is industry employment per dollar of industry output. These ratios have been calculated for the set of defense industries undergoing simulated cuts in procurement and the set of infrastructure industries benefitting from expenditure increases. Weighted averages of these ratios are presented in Table 7.

Table 7

Labor Earnings/Value-Added and Employment/Output Ratios Defense and "Rebuild" Industries
(average national values)

	Defense Industries	"Rebuild" Industries
Wages and Salaries per Dollar Value-Added	0.561	0.859
Employment per $100,000 of Output	1.39	2.03

Source: 1977 Multiregional Input-Output tables, Social Welfare Research Institute, Boston College.

The infrastructure industries, and particularly the service sectors (i.e. education, health, and social services) have extremely high ratios of labor compensation to total value-added. Thus, every dollar of value-added transferred to these industries from defense adds, on average, almost $ .30 to the national wage and salary pool. This increment translates into additional family disposable income, tax revenue, and ultimately more consumption spending and induced output. Moreover, the higher employment/output ratios in the "rebuild" industries are responsible for adding 6,400 jobs for every $1 billion of output shifted from defense to infrastructure[22]

The difference in the ratios between the two sets of industries explains an apparent enigma of Table 6: the fact that simulated wage and salary income generated is actually greater than the change in gross national product. For the nation as a whole, GNP is equal to the sum of industry value-added across all industries. A dollar shift in value-added from a typical defense industry to a typical "rebuild" industry will leave GNP unchanged. However, that dollar shift will generate an immediate $.30 of additional labor earnings which goes into the spending stream.

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[22] There is one additional factor that helps to explain the expansionary nature of the expenditure shift. Despite the "Buy American" proclivity of the DOD, it turns out that the import ratio for the set of defense industries is higher than it is for the "rebuild" industries. According to the simulation, the $35 billion shift in procurement transfers $1.4 billion from import demand to domestic production. This, by itself, might be responsible for as many as 35,000-40,000 of the net FTEs generated.

To be sure, the additional injection of wage and salary earnings is not a totally free good. It comes at the expense of a net decline in such forms of capital income as interest, dividends, rent, and retained corporate and non-corporate profits. This may reduce long-term private sector capital formation and at least partly detracts from short-term income flows. The latter is explicitly incorporated in the MRPIS model. The former is not. The decline in retained profits would be a potentially serious problem if it led to absolute reductions in total investment. However, in this particular simulation, overall (public plus private) capital formation is maintained by concentrating government spending on infrastructure.

Further analysis of this simulation reveals an additional set of salutary outcomes. Unlike the actual shift in tax and expenditure policy between FY1981 and FY1985, this hypothetical shift does not increase income inequality. Each income class benefits from nearly identical proportional gains in family disposable income. The redistribution between regions is also quite modest, although a small set of defense-impacted states including Connecticut, Washington, and Rhode Island do suffer absolute losses in total employment and aggregate income.

One should also note that this shift in resources toward infrastructure industries will most likely have a positive effect on productivity. The additional revenues spent on education and health should increase labor productivity, while the growth in physical infrastructure should contribute to more efficient transportation services and ultimately lower public utility rates for private industry.

There are two additional lessons about deficit reduction that can be gleaned from the "rebuild" simulation.

Lesson 4	Careful retargeting of federal spending patterns can result in economic growth plus ex post deficit reduction without cutting -- and indeed expanding -- needed civilian spending.
Lesson 5	Deficit reduction need not have the effect of further increasing income inequality.

The five lessons developed from simulations 1 and 2 can be useful, we believe, in designing deficit reduction programs over the next five years. Yet, there is a broader set of policy guidelines that should be followed. We turn to those in the last section of this paper.

Reducing the Potential Pain of Deficit Reduction

Virtually all of the rhetoric surrounding Gramm-Rudman has stressed the need for a wrenching, painful bout of fiscal belt-tightening over the next five years. The story goes that, as a nation we have been living on borrowed money and we must now pay for our profligate ways or face longer-term economic disaster. Drastic budget cuts for FY1987 and beyond, especially on the civilian side of the ledger, have already been drafted by the Office of Management and Budget and will soon be on their way to the Congress.

But before these spending cuts are put in place, it seems useful to consider several alternatives, suggested at least indirectly by the two simulations discussed above. Deficit reduction should be accomplished, as much as possible, with the following goals in mind:

(1) It should not jeopardize the already precarious state of economic and employment growth.

(2) It should be accomplished without further aggravating the nation's income distribution.

(3) It should, if possible, contribute to, rather than detract, from productivity growth and capital formation.

To meet these goals, deficit reduction should be approached in stages using the least invasive methods of remedy first.

Step 1 Redistributing federal spending priorities toward infrastructure development should be the first method used to hold the line on the deficit, and begin its reduction.

Step 2 The major problem posed by deficit spending is not the creation of debt per se. It is the growing interest payments on the accumulated debt that now absorb such a high proportion of present and future tax revenues. The most painless method to solve this problem is to reduce interest rates through continued monetary expansion, particularly in this period of low core rates of inflation. Reducing short-term Treasury rates by one to two percentage points could cut debt finance costs by approximately 25 percent. By itself, this could cut interest charges by nearly $35 billion -- more than half of the $60 billion FY1987 reduction mandated by Gramm-Rudman.

Step 3 To further reduce the deficit, the government should resort to temporary tax boosts before further cuts in non-defense spending. To assure that tax increases are born equitably, the Congress should act on tax reform first. A compromise between the Administration's Treasury II proposal and that hammered out under the leadership of Congressman Rostenkowski in the House would provide a tax system that will likely be more vertically equitable than the present system and further reduce personal income tax liabilities.[23] With the passage of tax reform, it would be possible to add a "vanishing surtax" to the basic streamlined rate structure. A surtax of 10 percent, raising the highest marginal tax rate to less than 42 percent (under Rostenkowski) would still leave marginal rates well below present brackets and would raise upwards of $40 billion in FY1987. As the deficit reductions targets were met, the surtax would be correspondingly reduced so that by no later than 1991 it could be completely abolished.

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[23] Analyses of the Treasury II proposal carried out by the Office of Tax Analysis and confirmed in a special simulation using the MRPIS model demonstrate that current personal income tax burdens would be reduced for most families under the proposed legislation, and the largest proportional benefits would go to low and moderate income families. See Department

Step 4 Only as a last resort should the Congress pass additional cuts in non-defense programs. These programs, as indicated in simulation #1, have already been subject to major cuts which resulted in significant income losses for the lowest income groups in the population. Further reductions in these programs will almost certainly lead to a further gulf between the "haves" and the "have nots" in our society. After more than half a decade of successful federal government efforts to increase inequality, using deficit reduction as the club to further bludgeon the poorer half of American families would seem to be a cruel and indeed needless act.

(continued)
of Treasury, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (Washington D.C.: Government Printing Office, May 1985) and Lynn Ware, John Havens, Barry Bluestone and Carol Pepin, "Treasury II Analysis," Social Welfare Research Institute, Boston College, November 1985.

Mr. ROWEN. Thank you, Mr. Bluestone. You now have an idea that if Barry Bluestone had been sitting in Paul McCracken's chair things might have been different.

Our next speaker, happily, is Paul McCracken. He is the Edmund Ezra Day University Professor of Business Administration at the University of Michigan. Dr. McCracken has been both a member and chairman of the Council of Economic Advisers and presently is a member of President Reagan's Advisory Board on Economic Policy.

PRESENTATION OF PAUL McCRACKEN

Mr. McCRACKEN. Thank you, Mr. Chairman.

First, I do want to extend my appreciation to the committee for what they have done to organize this effort. If I have any distinction on this panel it is that I myself span virtually the entire 40 years of the operation of the Employment Act, having first appeared before the Joint Economic Committee when Senator Taft was the chairman. That was back in the other era when the Republicans briefly controlled the Senate.

It's interesting to speculate about how fiscal policy in the 1980's would look or will look if we move ourselves 40 years ahead and assume that we are gathered here to celebrate 40 years of Gramm-Rudman. I dare say a significant percentage of this audience would not bother to come.

I agree with what has been a fairly common thread in the discussion this morning. The budget situation is not where it ought to be, and some rather vigorous measures are going to have to be taken to get it back in line. If I had to pick the kind of a target figure in quantitative terms, I would agree with John's target. We need to move toward a deficit 5 years hence in the neighborhood of $100 billion. That strikes me as a very sensible one.

Now looking through the tops of one's bifocals at this problem, it seems to me very clear that there's going to have to be action on both sides of the budget. Bob Eisner has pointed out that theoretically we could do something about this by selling the family jewels, but I assume that is not a serious alternative. That means to me that 40 years from now looking back at the budget policy problems of the 1980's, one conclusion will be reached. It was an era when fitfully and haltingly and perhaps painfully we were trying to find our way to reimpose stronger basic constraints of fiscal discipline.

The emergence of compensatory fiscal policy back at about the time the Employment Act was passed did of course liberate the management of economic policy from the constraints of the always balanced budget philosophy. But we do, I think, need to remember something. One of them was that by virture of the general consensus, that the budget ought always to be balanced imposed a fiscal discipline that worked. It did impose on Government the crude cost-benefit calculus that if you want to spend, you must tax. On the whole, it worked. If you look at the first 140 years from 1789 to 1929, according to my calculation, black-ink years outnumbered red-ink years about 3 to 1, excluding war years.

With the emergence of the view that there are times when the budget ought to be balanced or in surplus but there are times when

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it ought to be running a deficit, the basic concept of fiscal discipline was a baby that got thrown out with the bath water. It seems to me Gramm-Rudman, and perhaps a decade ago the passage of the Congressional Budget and Impoundment Act, must be seen in the context of feeling our way toward the reimposition of some kind of formal constraints beyond simply urging the Congress to try harder. That strategy alone will not work, will not do the job.

I also agree, however, that if we are to get the budget on a more balanced path by the end of the decade, we are going to have to have some additional revenue. My guess is, before the end of the current congressional session that will be generally recognized. There's room for this. This economy is not, in that sense, overtaxed.

Let me just indicate two or three quick things that would suggest that to me. For example, this will not be popular, but the tax on gasoline would have to be 10 cents a gallon higher than it now is, State and Federal gasoline taxes, in order that in real terms the tax on gasoline would be equal to what it was before the first oil crisis. In other words, in that sense, we have acted in an irrational way by encouraging gasoline consumption.

I might add that I proposed, about 10 years ago, a 30-cent-a-gallon additional tax on gasoline. This was when I was back at the University of Michigan. And it produced an all-time record response in terms of correspondence which was about 6 inches thick on my desk, and not a single person agreed with me on this.

We obviously are also going to have to come to grips with some changes in the income tax to increase revenues. This can be done. The individual income tax revenues at the present time are equal to a little less than 11 percent of total personal income. That is not an extravagant overall total and this leads me to a suggestion for the Senate as they consider the tax issue in the current session.

I would suggest that they be governed by two very simple rules about the ideal income tax. First, measure income correctly. Second, tax it. Once you start to let a sheep or two out of the corral, you will find what any farmer knows, you can't let just one or two out. And that's the problem we face at the present time.

Finally, I would also agree that we may well have to look at something like the value-added type tax, but the important thing is, we're going to have to work on both sides of the budget, and a part of the total process is going to have to be to find our way to introducing somewhat stronger fiscal discipline—something which got jettisoned along the way.

Mr. ROWEN. Thank you very much, Dr. McCracken. Perhaps later in the discussion you will tell us if you are making headway on the Advisory Council with that last recommendation on tax policy.

Let me remind the audience once again that if you want to have a chance to participate in this panel session by asking questions you will have to send questions up here and that will require you to raise your hand and get a card and fill out your question and have it brought up here.

Our final panelist is Alan Blinder, Gordon Rentschler Memorial Professor of Economics at Princeton and a Visiting Fellow at the Brookings Institution.

PRESENTATION OF ALAN BLINDER

Mr. **Blinder**. Thank you.

There is another committee in Washington—not the Joint Economic Committee—that sometimes sends me junk mail, called the Committee on the Present Danger. When Gramm-Rudman was passed last month, I finally knew what they were worried about. The Gramm-Rudman legislation does in my mind pose a clear and present danger to our economy, and indeed to our society. Ironically, this legislative catastrophe was induced by what seems to me to be a very easily solved economic problem. That is, reducing the deficit to manageable proportions, which is not to say to zero. Only politics could have made such an easy economic problem seem so difficult.

What I would like to do in the 10 minutes allotted to me is to run over with you some of the numbers that support this view that this is really an easy problem rather than a difficult one. I published some of these numbers in Business Week a month ago, and I apologize for repeating myself. But I just haven't changed my mind in 4 weeks. It still looks the same.

The first point I need hardly make, because Professors Makin and McCracken have already made it before me. It is that the deficit reductions that we really need are something in the neighborhood of one-half what Gramm-Rudman proposes to do.

One reason for that is the inflation accounting point that Bob Eisner barely mentioned. I thought he would spend more time on it than he did. Counting the inflation component of nominal interest rates as an interest expense is simply poor accounting, flat-out. It is not the way the Financial Accounting Standards Board—FASB—says businesses ought to keep their books in an inflationary environment. It winds up counting some principal repayment as interest expense.

In fiscal year 1987, the national debt held outside the Government will be something over $1,700 billion. At a 4 percent inflation premium, that's about a $70 billion mismeasurement—counting as an expense that which is not indeed an expense.

The other adjustment that we make to get down to about $100 billion is the adjustment for high employment. I'd like to remind every body that the Joint Economic Committee was formed as a result of the Employment Act of 1946. That was not the Unemployment Act of 1946. There was a view then that we ought to pursue full employment. A minority of us still hold that view.

We are not at full employment now. If the full employment rate is just one percentage point below where we are now, which seems to me a reasonable estimate, then another $30 billion of this deficit is simply attributable to the fact that the economy is below full employment.

So, if you add the $30 and the $70, you have about $100. The remaining $100 or $110 or $120 of deficit is the deficit in the full-employment budget under proper inflation accounting. And balancing that budget seems to me to be at least a potentially sensible budget norm, not balancing the budget as we measure it now is not.

Now to do this—that is, to find something on the order of $100 billion or $110 billion in deficit reductions—we simply must raise the base on which these reductions are to be made. Let me go over some numbers with you that were just published yesterday by the CBO and the OMB—as part of the first round of Gramm-Rudman.

Taxes for fiscal 1986—I'm rounding all these numbers—are expected to be about $780. And Government spending other than interest, which, of course, can't be touched, at least if we maintain capitalism, as I hope we will, are $860. If you add those two, you have a potential base for budget reduction of $1,640. We need to find $100 out of $1,640. That doesn't sound so awfully difficult.

However, out of that $1,640 base, the President has sought to exempt, first of all, all the taxes, that's $780; second, the defense budget, that's about $275; and third, with the Congress agreeing on this last one, the Social Security Program. If I lump Medicare into Social Security, that's also about $275.

If you make all those deductions from the $1,640 potential cuttable base, you are left with only $310 billion. And it's simply not easy to find $110 billion of cuts out of a $310 billion pot—not to mention the $220 billion cut that Gramm-Rudman says we're supposed to make.

The Gramm-Rudman Act does, however, put defense back into the cuttable pot, so that raises it to about $600 billion. But I think it's still tough to find $220 in a pool of $600. It can, of course, be done by a computer. That was the genius of the Gramm-Rudman bill. But there isn't any reason to think the computer will do it in any intelligent way.

So I think that everything would go down a lot easier if we were a little more sensible about this and got the cuttable base back up to the $1,640 potential.

Now, the third point is that the needed programmatic cuts are not as large as the needed deficit reduction. A lower deficit now will lead to a lower accumulated national debt later and also, because of that, to lower interest rates. For both of these reasons, the Government's interest bill will fall without any need to repudiate the national debt—either explicitly or through inflation.

I estimate roughly that, to cut $100 billion out of the deficit by fiscal 1989 or 1990, we would need something on the order of $70 to $75 billion in programmatic cuts. In a minute I will outline a plan using the number $72 billion as a spuriously accurate figure that is in that range.

It sounds strange to say that to cut the deficit by $100 billion we need only cut the programs by $72 billion. Usually, we think it's just the reverse, that the cut in the deficit will be smaller than the cut in Government spending because the multiplier will reduce income and have tax receipts. However, if the Federal Reserve targets GNP, either nominal or real, then the lost aggregate demand will be replaced by the Federal Reserve through easier money and lower interest rates, and therefore there need not be any effect on aggregate demand. That's what I think the Federal Reserve should do, and for moderate fiscal changes I think that's what in the current environment they actually would do.

Now let me outline briefly, in the 2 or 3 minutes left to me, a concrete plan for doing all this. My concrete plan, which by the way is not set in concrete and is subject to lots of modification, has three annual deficit reductions—three rounds in the 3 coming fiscal years, each of only $24 billion. That is not a lot of money in a budget the size of the federal budget.

I would take about half out of taxes. That's about $12 billon a year. And about half out of spending, equally divided among defense, Social Security including Medicare, and everything else.

For taxes, there are lots of things one could look at. Many of them have been mentioned already. That would be closing income tax loopholes, and raising taxes on liquor, on cigarettes, or on oil. All of those have been mentioned. It's not very hard to find three rounds of $12 billion.

The cuts in the defense budget that I'm talking about are truly very small, about a $4 billion cut per year for 3 years. That takes about 1½ percentage points off the growth rate of nominal defense spending.

A similar cut out of the Social Security budget would, for a typical Social Security recipient getting $500 a month, amount to a 25-cent-a-day reduction in the cost-of-living increase.

My point is that I don't see that any of these suggested changes in taxes and spending threaten the vital interest of any broad constituency in this country in any very important way. If looked at this way, it's hard to understand how a rational Congress could have been driven to the desperate act of enacting Gramm-Rudman.

Mr. Rowen. Thank you very much.

Let me put a general question to the panel that is suggested in part by what Professor Blinder just said about getting to a $100 billion deficit target and some of the remarks that Congressman Obey made about growth. And the quesiton is: How important is growth as a continuing economic goal? Can we go back as we once had to a goal of defining full employment as 4 percent unemployment, or do we have to listen to some of the economists who say that we can no longer stress growth because dealing with the structural unemployment problems we have, the industrial problems—will not be the proper course in this situation? We hear that particularly from economists in Europe. So, the question basically is, what should our goal on growth be and I think it's appropriate in the discussion of the Employment Act? Bob, may we start with you?

Mr. Eisner. I'd be delighted. I think it's a pity that we have so quickly abandoned our goals of full employment and the maximum growth achievable with full employment. The Humphrey-Hawkins Act claimed goals which apparently are completely ignored. We had 2.9 percent unemployment—without seasonal adjustment—less than 20 years ago. I don't know why my friend and colleague with whom I agree so much will not tell us that 6 percent is perhaps what we should consider full employment. I know of no changes in the economy, our population or anything else that justifies such a retreat.

If we are to pursue a budget policy in the interest of growth, we have to be very careful that we don't reduce capital formation broadly conceived. But capital formation is not just business spending for plant and equipment which powerful lobbies insist to the Congress have to have all kinds of special tax treatment. Capital formation includes huge amounts of public investment in real property, in education, in research, and the things that really do contribute to our future productivity.

I think these goals should be foremost and any budget policy has to come to grips with them.

Mr. Rowen. Any other member of the panel want to join in on that?

Mr. Makin. I want to remind us all that one way to encourage growth is not to pass a law. I would point out that since the passage of the Employment Act in 1946 the unemployment rate has risen steadily.

Mr. Rowen. Which you attribute to the passage of the Employment Act?

Mr. Makin. No; I attribute it, unlike Bob, to demographic changes, more attractive—unemployment is a good deal more attractive now than it has been in the past, a number of demographic agences such as participation in the labor force by women, et cetera, et cetera.

What should we do to encourage growth? Step 1 in the context of today's discussion, pass a sensible reduction in prospective deficits. I think Alan Blinder has outlined a fairly sensible program. I would lean on the side of consumption tax to pick up the tax side of the program.

Second, follow a credible and stable monetary policy. I would strongly disagree with Professor Bluestone that having during 1985 seen the Fed double their projected rate of money growth, double it again. There, we would see more inflation and the experience is that monetary policy is not a sufficient or adequate way to encourage growth over a sustained period.

Mr. Rowen. Paul McCracken.

Mr. McCracken. Two quick comments. While we certainly need to keep in mind our objectives, perhaps even in quantitative terms, the genius of the Employment Act of 1946 is to be found in part by the fact that no quantitative numerical goals are embedded in the act. It's not without significance that the Employment Act has endured and we are here 40 years later and the Humphrey-Hawkins Full Employment Act, which does have embedded in it some specific numbers is largely ignored.

The second point. The 4 percent figure never did have much rationalization in history. History would have suggested for that time a figure of about 5 percent.

Mr. Rowen. Barry Bluestone.

Mr. Bluestone. Just briefly, I think we can benefit from a little bit of history in terms of those numbers. The fact of the matter is that right now in a number of States, including Massachusetts, the unemployment rate is hovering around 4 percent. It's been there for a couple of years in my State. We have fairly liberal unemployment insurance benefit laws, and fairly liberal AFDC and other social service programs. We have fairly high taxes. And yet, we have been able to maintain very low unemployment rates, including those for minorities. The latest number for non-whites in Massachusetts is 5.6 percent.

The question is, how do you develop a growth strategy which allows more and more areas of the country to have the same kind of growth that Massachusetts and a number of other industrial States have experienced?

Mr. Rowen. Professor Blinder.

Mr. **Blinder**. In answer to your question, I'd like to say that my view is that keeping unemployment low and growth high is, as it was in 1946, the most important objective of national economic policy.

I don't however, think we can realistically shoot for 4 percent unemployment any longer, for some of the raesons that John mentioned and for other reasons.

We have to do this by switching the policy mix—as everybody has been saying for many years—toward a tighter fiscal policy and a looser monetary policy. And I'd just like to add, as a footnote to that, that on balance I would like to see this swap made so that on net aggregated demand, increases not decreases, because I just can't see the case that 7 percent is full employment.

Finally, as to the structural problems that you mentioned, that get mentioned in the United States with some regularity—once a decade or so, and that are mentioned so much in Europe, I think they are in large measure an excuse. A lot of these structural problems would melt away here, and also in Europe, with a high pressure economy.

Mr. **Rowen**. If not 4 percent, what's the number?

Mr. **Blinder**. I like to use a number between 5½ and 6. You can split the difference.

Mr. **Rowen**. We have several questions from the audience relating to the estimates that some of you made that $100 billion deficit would be a fair figure. They want to know whether or not you're talking in 1986 or in 1991 dollars.

Mr. **Makin**. 1991 dollars.

Mr. **Rowen**. Was that the assumption the rest of you were making when you talked $100 billion?

Mr. **Blinder**. Yes.

Mr. **Rowen**. A question from Professor Davidson of Rutgers University addressed to Bob Eisner. What difference does it make except in an accounting sense if we sell off earning assets to solve a cash flow problem rather than to borrow against those assets?

Mr. **Eisner**. That's a splendid question which almost answers itself. It's no particular advantage. That is, if you're selling off earning assets you're going to be taking cash away from the public. One of the arguments which I think is overdone, but one of the big arguments about the cost of the deficit is that it is taking money from the private sector that could otherwise go to finance new investment, capital formation. Well, it's not going to matter much if you take the money from the private sector by having people buy Government bonds or by having them buy anything else from the Government. You're still taking that money away from the private sector and having, as far as that goes, the same effect.

Mr. **Rowen**. Any other comment?

[No response.]

Mr. **Rowen**. Given the size of the trade deficit and the corresponding state of the manufacturing sector, including defense, and given the massive upsurge in consumer credit, how could the spending reductions mandated by Gramm-Rudman not result in a massive recession?

Well, we could spend I guess the rest of the morning on that. Does anybody want to take a quick crack at it?

Mr. **Makin**. Let me talk about the relationship between where we've been and the trade deficit. We have in the first 5 years of this decade learned something new. That is, if you pursue policies where you stimulate investment as we did with the changes in the tax law in 1981, and you don't stimulate savings, and you run a large fiscal deficit, then in order to finance the increase in investment you have to import the savings. As you import the savings, your currency appreciates. The mirror image of savings flowing in is a big trade balance deficit.

One of the ways to relieve the problem would be to encourage savings. So, to answer the question, one of the ways to address the Gramm-Rudman goal or a less ambitious goal would be to adopt tax increases that encourage savings; that is, a consumption-based tax.

Mr. **Rowen**. Professor Blinder.

Mr. **Blinder**. I tried to address that question a little bit in my opening remarks. My view is that for moderate reductions in fiscal stimulus by higher taxes or lower spending, the Federal Reserve is likely to step in and resupply the aggregate demand that was lost. So you don't get any recessionary impact. That's a guess, of course. We don't know that that's true. But the other part of my guess is that for the very large fiscal reductions that Gramm-Rudman may trigger somewhere down the line I have no confidence at all that the Federal Reserve will step in and provide that much monetary stimulus. And that's where I think the danger of recession does indeed lie.

Mr. **Rowen**. Any other comments?

Mr. **McCracken**. I would agree with what Alan just said. I do think historically again, being the elder here I tend to think historically, that we have tended to overestimate the near-term adjustment problem incident to trying to get where we would like to go in the longer run and therefore we keep finding ourselves out of position.

I would be a little more optimistic about the capability of the economy to adjust to fairly large changes than perhaps would be the general view.

Mr. **Rowen**. From Jackie Simon of the AFL-CIO, why hasn't anyone mentioned the politically popular and economically rational restoration of the corporate income tax? Under the Reagan administration, effective corporate tax rates have dropped to 14 percent with many of the largest corporations, which incidentally profit most from defense contracts, pay zero or less in taxes. I would especially like Barry Bluestone to comment on this.

Mr. **Bluestone**. Both the Treasury II proposal and the Rostenkowski compromise bill do increase corporation income taxes and provide for personal income tax cuts. I think that goes in the right direction. What we need to do is to pass a tax reform measure this year which would make it possible to temporarily raise tax rates above those in the present compromise version as well as Treasury II.

Tax reform, it seems to me, is a good idea whose time has come. It's a whole lot better than doing anything with Gramm-Rudman directly and, in fact, that's the direction I would like to see us go.

Mr. **Rowen**. Mr. Eisner.

Mr. **Eisner**. There is an argument that businesses don't pay taxes, people do. What's wrong with the current corporate tax structure is that we have such huge loopholes and some corporations pay taxes and many don't pay any at all. I do think that the House version has made a major improvement and I hope the Senate will not junk it. The House changes in depreciation along with the elimination of the investment tax credit will at least restore some balance to taxation of business and stop the huge distortions of the tax structure introduced.

I might add, in all of these budget proposals to reduce the deficit we ought to be careful that we're not singling out some particular group or adding to distortions or adding to lack of equity. And I don't quite understand why so many people join in the chorus and say: "Well, we should perhaps cut defense, raise taxes and cut Social Security." If you're cutting defense you're cutting something which maybe we should cut, that affects presumably all of the people. If you raise taxes you can raise taxes in such a way that you raise them for all the people. If you cut Social Security you're cutting benefits for a particular group, for people over 65.

Now, who has formed the judgment that people over 65 somehow are living too high off the hog and in general should be cut? I don't know where that judgment comes from and I don't know why it is developing such a conventional wisdom that one way to reduce the deficit that we should all agree upon is not to make Social Security sacrosanct. I say don't single out any particular group to cut the deficit unless you have good reason to do so.

Mr. **Makin**. If I could just add a comment on Social Security in reply to Professor Eisner's question, I think the reason that we are looking at Social Security is that Social Security benefits have risen twice as fast as real wages in the last 30 years and the per capita income of the retired population is above that of the working population.

When we're talking about Social Security benefits in the context of deficit reduction, we are not talking about cutting them but we're talking about omitting a COLA adjustment for 1 year which reduces the base and over a 5-year period at 4 or 5 percent inflation saves you something between $60 and $80 billion.

Mr. **Rowen**. Anyone else?

Mr. **McCracken**. Yes; it is for precisely these reasons that I suggested my two rules—measure income correctly and then tax it universally.

Mr. **Rowen**. OK. No one has addressed the issue of high real wages in the United States that are expected to continue to cause transfer of jobs to other locations, primarily the Third World, through multinational corporations. With real U.S. wages 150 to 300 percent of those in the developed world on the average, disequilibrium will continue for the foreseeable future. Please comment. Do we have any volunteers?

Mr. **Bluestone**. I do not think that high real wages is the problem with the American economy. Our economy is a growth economy, or it should be. Our economy should be one that sees increasing standards of living and, for most people, that's through increased wages.

The problem we face is the problem of high unit labor costs. That is, our wages have at times—not in recent times—exceeded productivity gains. What we need to do is to rebuild the American economy so that we are increasing productivity which allows us to increase the standard of living and continue to have rising real wages.

Mr. ROWEN. Alan Blinder.

Mr. BLINDER. I would like to endorse that and just add two things. The first is that the wage gap between the United States and the rest of the world was far larger in the 1950's and 1960's than it is now, and we had no difficulty then competing abroad—mainly on the basis of better productivity. Second, part of this wage gap is a transitory and unfortunate consequence of the distorted exchange rate that we have been living with for the last few years but hopefully are now in the process of getting rid of.

Mr. EISNER. I'd just like to stress that exchange rate matter. All these international comparisons depend critically upon the exchange rates. To the extent we have that problem, exchange rates have now turned about 25 percent in our favor very quickly with the depreciation of the dollar. And we can do much more if we feel we should by simply applying the ordinary laws of supply and demand. If you supply more dollars, and the Federal Reserve can do that, then the value of the dollar will go down.

Mr. MAKIN. The value of the dollar will also go down if we reduce deficits. I don't think we'd get any argument on that. So Gramm-Rudman or a deficit reduction program is part and parcel of enhancing international competitiveness.

Mr. MCCRACKEN. The distortion in the exchange rates, of course, has been a very large part of this problem. By the way, this matter is more than just multinational corporations. It expresses itself of course through trade generally.

I do think, however, that the rapid internationalization of the economy, even with reasonably adjusted exchange rates, is going to leave significant segments of industry with a cost problem, and we need to be aware of that.

Mr. ROWEN. It is expected that Gramm-Rudman will require at least a $60 billion cut in the deficit for fiscal year 1987. What do you anticipate will be the short-run effect on growth and employment from this substantial change in fiscal policy? That's the question handed up from the audience and since this is likely to be the last round of answers let me just add to that, and ask you if you would suggest why it is, at the same time you answer this question, if $100 billion is a much more reasonable target the Congress hasn't had the sense to tackle it that way?

Mr. BLINDER. Could I throw that question to the people sitting on your right side? I've been asking that myself for a long time and haven't had an answer.

As to the question that came from the floor, I first of all don't think the $60 billion cut in Government spending will take place. There are a variety of scenarios in which it doesn't take place—one of which is that the President says, "If $30 billion is supposed to come out of defense, I can't leave the Nation vulnerable in that way, then the game is off, and we don't do the Gramm-Rudman cuts this year.

Should I be wrong about that, so the cuts do come into effect, and there's at least a 50 percent chance that I am wrong, because this is a political guess—I am than worried that the Federal Reserve will not take a sufficiently aggressive monetary stance to cancel the downward effect on aggregate demand of such a large cut in spending.

Mr. **Eisner**. I'd like to get back to the question of what deficit we're talking about cutting. Under Gramm-Rudman the options are stupendous and I think may lead to the kinds of disasters which we haven't figured out. For example, under Gramm-Rudman I presume you can reduce the deficit by $60 billion by selling the White House and renting it back, by selling the Bonneville Dam, which has been proposed, by selling off earning assets of the Government and affiliated credit agencies, by selling all the mineral rights on Federal land, perhaps at a song. We can do those things and technically we will meet the goals. That I think is bad economic policy to do at least on those grounds and will have repercussions over the long run.

If you really reduce the deficit by $50 or $60 billion, then as just pointed out you will have serious problems from such a rapid reduction of the deficit, serious problems in aggregate demand which monetary policy may not be able to meet.

Mr. **Makin**. I think the question raises the issue that we've been talking about very clearly. That is, $30 billion in reduction would be a good thing, $60 billion would be a bad thing. In other words, if you reduce the deficit by a sensible amount—that is say $30 billion—I think we would get some dollar depreciation; we would get some interest rate cuts, especially if it's a convincing perspective reduction. And those stimulative effects of lower interest rates and an easing dollar would compensate partly for the direct destimulation from deficit reduction.

The problem with the $60 billion cut is the direct effect is more than can be offset by the lower interest rates and the easier dollar.

Mr. **Bluestone**. Briefly, my comment about Smoot-Hawley at the beginning of my talk was not facetious.

Mr. **Rowen**. Dr. McCracken, you're going to get the last word.

Mr. **McCracken**. $60 billion is a little ambitious. I would guess it would not occur to that extent. I would emphasize what I've mentioned before. I think we persistently tend to underestimate the capability of the economy to adjust to even major changes in the budget. That seems to me to be the clear lesson of history as you look back at post-World War II, after the Korean conflict, and after Vietnam.

Mr. **Rowen**. We thank you very much. There will be no more than about a 2-minute intermission while the next panel gets in place. We thank you very much for being such an attentive audience.

[Applause.]

Chairman **Obey**. If we could have your attention, please, we would like to resume. We would like to finish this next panel as close to 12:30 as we can before we move over to the luncheon.

The second session of our symposium this morning will look at the macroeconomics of growth, full employment and price stability.

In 1946 the prime concern of policy makers was that postwar demobilization could lead to a massive rise in unemployment. The Employment Act thus called for policies to promote maximum employment in the last 1940's and in the Korean was years the focus began to shift to the fight against inflation. Later in the midfifties concern arose about the adequacy of our rate of economic growth and proposals to improve it were put forward and since that time we have really repeated that cycle of concern.

There are a number of question, a good many more than I will cite, but there are a number of questions which we have to ask about that problem because macroeconomics in that sense does appear to be in a state of confusion.

Is inflation dead? Why do we seem unable to get the unemployment rate down further even with our current economic recovery? Are we seeing the reemergence of demand as an important threat to economic growth—inadequate demand anyway? If we truly need more sayings what should we be willing to give up to get it? How do we achieve the interplay between fiscal and monetary policy and market forces needed to get the country on a stable path?

To help us better understand these questions we have a distinguished panel with us this moring and we have a distinguished moderator for that panel, Mr. Leonard Silk, who is an economics reporter as all of you know for the New York Times, and the author of one of the most widely read colums on economic issues. And if I could also editorialize, he is also a product of the University of Wisconsin which gives him special distinction, at least this morning.

PANEL: THE MACROECONOMICS OF GROWTH, FULL EMPLOYMENT, AND PRICE STABILITY—LEONARD SILK, MODERATOR

Mr. Silk. Thank you very much, Representative Obey. It is indeed an honor to be a graduate of the University of Wisconsin and the moderator of this panel.

The title of our part of the discussion today is the macroeconomics of growth, full employment, and price stability.

Those of us who reach back to the dawn of the Council of Economic Advisers and the Joint Economic Committee remember that the original Employment Act had only one of those terms that was its direct concern. That is employment, and unemployment by implication.

I suppose today, if I were really going to string out the title of our session, it would be, given all that has happened especially in recent weeks, the macroeconomics of growth, full employment, price stability, budgetary balance, lowering the dollar, and eliminating the trade deficit, or words to that effect.

Well, to discuss the various aspects of all these things an act that was born in intense controversy will I'm sure continue in intense controversy and our leadoff hitter is James Tobin, Sterling professor of economics at Yale University, a recipient of the Nobel Prize in Economics in 1981. He has served as a member of the Council of Economic Advisers during the Kennedy administration. Jim Tobin.

PRESENTATION OF JAMES TOBIN

Mr. TOBIN. Thank you, Leonard.

I do consider myself a veteran soldier enlisted under the banner of the Employment Act. I would like to dedicate my remarks to three deceased soldiers of the Employment Act. I wish they were here today: Arthur Okun, Kermit Gordon, and William Fellner, they were colleagues of mine at Yale or here in Washington.

Today I think the auguries for the Employment Act and for policy under the act are mixed. On the one hand, we see the machinery of the Employment Act, the Council of Economic Advisers in particular, and the objectives of the act largely disregarded in the making of policy in the Congress and in the executive.

On the other hand, the external circumstances, the economic climate, seems good for a revival of the aims of the Act. I think it's high time, as some panelists in the earlier panel said, to raise our sights, to break the dismal trend upward in unemployment in successive business cycles that Congressman Obey mentioned in his introductory remarks.

We know that the main obstacle to achieving lower unemployment has been concern, often justified, over the inflationary consequences of low unemployment rates. In fact, we've had six recessions beginning in 1957, all of which could be interpreted as deliberately contrived recessions in order to contain or reduce inflation.

Today I think the climate is quite favorable—the stagflationary shocks of the 1970's are behind us, and some of these variables are moving in favorable direction instead. To read the last 18 months of 7 percent unemployment as indicating that 7 percent of our natural rate of unemployment is as good as we can do, I think is Panglossian economics at its worst.

As Alan Blinder said, I think we should push forward to lower unemployment rates. We don't know what the inflation-safe rate is today. The evidence of the 1970's is quite useless. As long as inflation is quiescent and all signs of wage-cost or demand pressures are as benign as they are now, we ought to be moving with deliberate speed to get the rate of unemployment down—to six and maybe lower. We can see with experience.

There are great gains from doing so. Each point of unemployment is worth $100 to $120 billion of GNP. That's not to be sneezed at. Of that, maybe $50 billion would be extra national saving, of which, $30 billion would be a reduction in dissaving by the Federal Government.

The war on poverty, investment for long-term growth, and other economic goals would gain a lot more than they will gain by any other tax or incentive policy that you can think of.

Under the present circumstances, moving toward lower rates of unemployment and fuller rates of utiliziation of capacity is a task for the Federal Reserve. There is reason to believe that the Fed has been moving away from monetary growth targeting and toward macroeconomic performance as its guiding principle in monetary demand management. I hope that's true. If it is true, then they will take further expensionary steps regardless of what that means for monetary growth rates. They will do so just because unemployment is still too high and there's still slack in the economy. They will do so all the more if there's reduction in fiscal stimulus under Gramm-Rudman or other budget policies. To offset the reductions in fiscal stimulus we would need a bold, active monetary policy during the transition to lower deficits and to a balanced budget. That would mean high rates of monetary growth at some point during the transition, The Fed needs to be willing to follow such a policy and to explain it to the public.

Since monetary policy is carrying the macroeconomic ball, the Congress needs to insist that the Federal Reserve does its part. When the Fed comes before the Committees twice a year to make their monetary report, the members should discuss with them what their true targets are for growth of GNP, and should hold them accountable for meeting them.

I agree with Alan Blinder that the coast is clear for expansionary macropolicy. But it's still true that even if we get down to 6 or 5½ percent unemployment, that's still too high. Doing better than that will require structural reforms of various kinds. The time to fix the roof is when it's not raining. I think the JEC could perform a public service by studying the whole question of structural reforms that might make it possible for us to move the unemployment rate further down. I have in mind Government regulations, minimum wage, Davis-Bacon, farm price supports, unemployment insurance, labor laws, and wage-price policies.

I turn now to the monetary-fiscal mix. As far as shortrun demand management in the economy is concerned, fiscal and monetary instruments are substitutes. The total dose of the two together is what you need to get any given overall performance with respect to employment and inflation. It doesn't really matter much what the mix of the dose is; the output, employment, and price consequences will be much the same.

During a time of fiscal tightening, if monetary policy is expansionary, it is not automatically inflationary, because an expansionary dose of fiscal medicine is being removed in equivalent amount.

The mix of monetary and fiscal policy that we drifted into in recent years is bizarre and extreme. It is unprecedented historically in this country. It is not viable in the long run. The reason is that it would mean, if continued, an unending increase in the ratio of public debt to GNP. That's because the policy mix produces interest rates that on public debt are higher than the sustainable long-run growth rate of the economy. Thus, if you had no deficit beyond the interest burden, the debt would be growing faster than the economy. That's got to be changed.

We could stabilize the debt-to-GNP ratio at the 40 percent or 42 percent that is the consequence of the $100 billion deficit in 1991 recommended earlier today. Or we could try to stabilize it at a lower ratio, back to 25 percent as in the 1970's. That would give us a somewhat more ambitious target for deficit reduction.

Another reason for preferring an easy money-tight budget mix to what we have now is that it's better for long-run growth. It dedicates more of national output to investment and future oriented activities, less to consumption and present oriented activities. There are qualifications to that generalization but since my time is being Gramm-Rudmanized I'm not able to go into them.

The fact that domestic investment has done well in the recent recovery does not contradict what I said. It's done well at the expense of being mortgaged to the rest of the world. We've drawn down our foreign investments, and it is a present-oriented rather than future-oriented use of resources to be borrowing from abroad for imports.

Fiscal policy was the favorite tool of economic stabilization policy at the time the Employment Act was passed. It was used for many years, both to get out of recessions and to cut down excess demand during booms. Leon Keyserling is here. During the Korean war, when he chaired the CEA, the Truman administration raised taxes sharply to pay for the war, a precedent that regretably was not followed in the Vietnam war and the Reagan buildup.

Fiscal policy is now completely incapacitated, as far as I can see, as a tool of countercyclical stabilization. For one thing, the deficits are just too big. No one would even think of adding expenditures or cutting taxes if there were a recession. Gramm-Rudman makes it worse because it will require that taxes be raised or expenditures cut even when the economy is operating at very low levels. We will have to make up for cyclical deficits under Gramm-Rudman. That's perverse policy, a great mistake. I know there are some escapes in the law but they are not sufficient to avoid the consequences I have just pointed out.

The burden falls on monetary policy, as I said earlier. We must depend on monetary policy to prevent recession but to end the stagnation of the last 18 months. Moreover, a much more active and bolder policy will be needed to offset the reduction in fiscal stimulus than the Fed is accustomed to.

Once this transition is made, I think there is good reason for optimism for the rest of the century, that it can be a period of stability and growth—the more so if some pragmatic realism is substituted for ideology in the management of the economy. As an aged veteran naturally dismayed by the wholesale and bipartisan dismissal of any ideas and policies that were current before 1980, I look forward to the time when rediscovery of those ideas and policies, those forgotten "oldie-goldies," will be hailed as new. [Applause.]

[The complete presentation of Mr. Tobin follows:]

Joint Economic Committee
Symposium on the Fortieth
Anniversary of the
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FISCAL AND MONETARY POLICY UNDER THE EMPLOYMENT ACT

James Tobin, Yale University

As we observe the fortieth birthday of the Employment Act, the auguries of its future are mixed. On the negative side, the objectives to which the Act committed federal economic policy --maximum employment, production and purchasing power-- command little support in word or deed among legislative and executive makers of policy. The Council of Economic Advisers, the major institution established by the Act to implement that commitment, has lost status and influence. Its attention has shifted to lesser goals. The Joint Economic Committee, more faithful to the original mandate but ever handicapped by its lack of legislative function, has difficulty getting its voice heard. The ideology dominating economic policy since 1980 rejects the premises of the Act, denying that federal interventions can improve the performance of the economy.

On the positive side, the economic climate over the foreseeable future is more clement than it has ever been since the twentieth birthday party. Nothing now on the horizon threatens the historically extraordinary series of external shocks that dominated the scene and preoccupied policy-makers throughout the world from 1966 to 1981 --notably the Vietnam war and the two oil crises of the 1970s. Now the OPEC cartel is collapsing and energy prices are falling. What is missing is commitment and confidence to take advantage of the benign climate of this decade.

Consider the complacency, resignation, and indifference with which the stagnation of the economy these last eighteen months has been accepted. The recovery that began in late 1982 stalled in June 1984 at 7% unemployment, give or take a couple of tenths, and at about 80% capacity utilization. My esteemed fellow panel-member Herb Stein has interpreted the experience to signify that those numbers are equilibrium values, "natural rates." I was dismayed to find him subscribing to Panglossian macroeconomics. In my own view, this low-level stability reflects not an optimal equilibrium but the inadvertence or excessive caution of the monetary authorities. Certainly the architects of the Act, and those who took it seriously over its first quarter century, would not have been content. They would not brag about real GNP growth barely fast enough to keep high unemployment rates from rising further, nor congratulate themselves on avoiding outright recession. Observing that wage and price inflation rates are subsiding and seeing no bottlenecks or shortages on the economic landscape, they would wish to push the economy with deliberate speed towards higher utilization of its capacity to produce.

Unemployment and inflation.

The Employment Act did not specify any numerical target for unemployment. That was wise, because feasible targets have varied from time to time and will vary in future. Particular Administrations and Congresses may adopt and announce numbers --like the 4% of the Kennedy years-- but only as interim goals to be reconsidered with experience. It was a great mistake for the Congress to enshrine in the Humphrey-Hawkins Act numerical goals for unemployment and inflation that were in combination patently unachievable in the 1970s, in contrast to the 1960s. The result was that policy-makers could ignore not only the numbers but the spirit that motivated them.

The Employment Act is directed first of all to fiscal and monetary policies affecting aggregate demand for goods and services. Inflation is the systemic constraint on the use of demand stimulus to lower unemployment and to increase utilization of productive capacity. All six recessions the United States has suffered in the last thirty years can be attributed to deliberate policies to restrict aggregate demand in order to bring inflation rates down. The counter-inflationary objectives were generally achieved, but with serious interruptions to economic growth and long intervals of high unemployment and excess capacity. Distaste for rising inflation rates, and indeed for persistent inflation above 5%, is a strong revealed political preference of the American public. There is good reason, therefore, to keep enough slack in labor and product markets to avoid substantial risk of triggering a spiral of accelerating prices.

The natural rate of unemployment already mentioned is conceptually the lowest "inflation-safe" rate obtainable by expansion of aggregate demand, the lowest rate that fiscal and monetary policies can be expected to achieve. Unemployment may be, probably is, still excessive at that rate. but further reduction requires structural reform along with fiscal and monetary demand management.

It is important to be clear about what the inflation limits to demand management do and do not mean operationally. First, no one can be sure what the inflation hazards are at any unemployment rate in given circumstances, only that they are greater at 7% than at 8% and at 6% than at 7%. Second, no one can guarantee that there is zero inflation risk; it would be silly and wasteful to run the economy with so many resources idle that inflation risk was negligible. Third, the hazard to be avoided is as continuing, pervasive acceleration of prices. One-shot boosts of particular prices and even of general price indexes are bound to occur, especially in cyclical recoveries; they are not a problem even though they make statistical measures of annualized inflation rates temporarily high.

Today we do not know what the inflation-safe unemployment rate is, even if we could agree on how little inflation risk that concept should imply. I don't know; Herb Stein doesn't know; Paul Volcker doesn't know. The fact that inflation rates rose at successively higher unemployment rates --from 3-4% in the late 1960s to 5% in 1973 and 6% in 1979-- is doubtless an influential reason for caution today. However, I think this history is useless evidence for policy in this decade. It tells us nothing about normal labor and product markets today; if it describes any natural rate, it is the "natural rate" of energy consumption and oil imports in the trying decade of the 1970s.

Now there is good reason to believe the natural rate of unemployment is well below the current rate of 7%. Both wage inflation and commodity price inflation are still declining. Workers and their unions are still desperately afraid of losing jobs. Employers are scared of losing markets, and in many cases of going broke. Both are frightened of foreign competition. Changes in industrial structure and comparative advantage have hit particularly hard those industries and unions whose price and wage behavior used to set extravagant patterns for a large part of the economy. So long as these benign conditions prevail, I think we should persist in gradually reducing the slack in the economy.

The situation today reminds me of the early 1960s. Two recessions in

1957-58 and 1960 had taken unemployment from around 4% to 6 or 7% and reduced inflation from a peak between 4 and 5% in the mid-fifties to less than 2%. Nevertheless, influential opinion in the Federal Reserve and elsewhere opposed measures to expand aggregate demand, on the grounds that they would be inflationary and that the increases in unemployment were structural rather than cyclical. These diagnoses and fears turned out to be groundless in the 1961-65 expansion, which lowered unemployment to 4% without adding perceptibly to inflation. Although 4% unemployment is not a realistic objective for aggregate demand policy now, we can surely lower the rate to 6% or less.

The gains from completing the recovery and boosting the utilization of existing productive resources are insufficiently understood and appreciated. Unemployment is privation for those affected, often pushing them below the poverty line. Unemployment compensation does not make them whole, materially or psychologically. Most unemployed are not even eligible. But from a society-wide point of view, unemployment is a waste of productive resources, whether or not the individuals unemployed suffer hardships.

The unemployment rate is a convenient cyclical barometer of macroeconomic performance; production, capacity utilization, and income are all strongly negatively correlated with under-utilization of labor. So is the overall incidence of poverty, far beyond the personal privations of those unemployed. Each point unemployment is lowered gains from 2 to 3% of GNP, about $100 billion. Of that, some $40-50 billion would be saved by businesses, households, and governments --the federal deficit would go down by $25 billion,-- adding to domestic investment or diminishing overseas borrowing. No tax incentives or other supply-side nostrums could do as much for saving and investment. For this reason, the high employment commitment embodied in the Act of 1946 is important, indeed essential, for long-run growth.

Demand management and structural policies.

Why is unemployment so high at "full employment?" That is, why is the inflation-safe unemployment rate so high? What explains its distressing and apparently inexorable upward drift these past twenty years? Perhaps the "natural" rate is just a moving average of actual rates; perhaps the recessions engineered to cope with the inflationary shocks of the 1970s have left us an unpleasant legacy. Perhaps, as suggested above, the natural rate today is a lot lower than generally believed. Anyway, it is too high.

The time to fix the roof is when it is not raining. Structural unemployment, beyond the reach of macroeconomic demand policies, afflicts disproportionately certain vulnerable demographic groups, teen-agers, young adults, minorities. Labor markets are very imperfectly competitive. The interests of unemployed outsiders are insufficiently represented in wage-setting decisions and negotiations, where the claims of insiders, senior job-holders, take excessive precedence.. Prior to 1981 Administrations and Congresses were at least concerned with these problems. They sought to ameliorate them by both labor market and wage-price policies, not very successfully, to be sure. Those approaches are not fashionable today. But the problems are still there, and the issues will recur.

I suggest that this would be a good topic for major study by the Joint Economic Committee. The agenda could include a number of ideas how to lower the inflation-safe unemployment rate: improvements in public education;

relaxation of minimum wage laws and other regulations that limit the downward flexibility of wages and prices; encouragement of labor contracts that relate wages to firms' revenues, profits, or labor productivity; penalizing by unemployment insurance surtaxes employers who raise wages while they are curtailing employment or while unemployment is high in their localities; annual economy-wide guideposts for wages and prices, with compliance induced by tax-based rewards and penalties.

Demand side, supply side.

Clear thinking about macroeconomic policies requires distinction between aggregate demand and aggregate supply and beween the effects of policies on demand and supply. Potential real GNP is the output the economy can produce with unemployment and capacity utilization at their inflation-safe rates. Its growth trend depends on the growth of productive resources, labor and capital, and on productivity-raising technological progress. Its level also depends, as noted above, on the amount of slack in the economy deemed necessary to contain inflation. Structural reforms, including "supply-side" measures, may increase potential GNP and/or its growth rate. But experience suggests that such effects are small and slow, difficult to discern and predict. The sources of productivity growth are elusive; its decline in the 1970s remains a mystery to the leading students of the subject. The supply-side measures of the 1980s have yet to bear fruit in potential GNP.

Actual real GNP fluctuates irregularly around the potential trend, generally in response to demand-side shocks or to policy-induced changes in aggregate demand. The two kinds of demand management policies available to the federal government are fiscal and monetary. Choices among the several fiscal and monetary instruments available may also affect potential GNP, in the future rather than contemporaneously. We must distinguish short-run demand stabilization from long-run growth in potential output, and sort out the effects of policies on these two goals.

Fiscal policy as demand management.

The sponsors of the Employment Act expected fiscal policy to be the main instrument of short-run demand management, and it was in fact actively used. In almost every recession prior to the most recent pair of 1979-82, fiscal stimulus, temporary or permanent, was deliberately applied to promote recovery. It took the form of extra purchases of goods and services (e.g. public works) or transfer payments (e.g. enlarged social security or unemployment benefits) or tax cuts. In 1964 income taxes were cut during a recovery, in order to keep it alive. On several occasions fiscal instruments were used to restrain aggregate demand during booms; taxes were increased sharply during the Korean war and belatedly during the Vietnam war.

Deliberate changes in budget programs and revenue legislation, sometimes adopted in the interests of macroeconomic stabilization, are to be distinguished from the built-in automatic contributions of the federal budget to stability. Without programmatic or legislative actions, tax collections fall during recessions and rise during recoveries and booms; likewise certain expenditures, especially transfers to the unemployed, the poor, and other victims of hard times, move counter-cyclically. As a result, private purchasing power falls less than business activity in slumps and rises less in prosperities. Built-in stabilizers do not prevent or reverse cyclical swings, but they do reduce their amplitude.

The well-known counter-cyclical movements of federal budget deficits or surpluses are just the mirror image of the partial stabilization of private spending power. Large budget deficits have usually been passive symptoms of weakness in aggregate demand throughout the economy, rather than indicators of increased active fiscal stimulus. The "high employment budget deficit," now returned to popularity as the "structural deficit," corrects for these cyclical effects, measuring what the budget outcome would be under existing programs, entitlements, and tax codes if the economy were operating at a constant rate of utilization of potential output. Changes in this deficit (often a surplus in the past) are a fairly accurate measure of the changes in aggregate demand due to fiscal policy, whether for stabilization purposes or for other reasons.

The stronger are the built-in stabilizers, the less need there is to resort to discretionary changes in the structural budget in the interests of demand management. Presidents Kennedy and Johnson, seeking to reinforce the automatic stabilizers, proposed some semi-automatic triggers for altering certain taxes and expenditures for counter-cyclical stabilization, but Congress did not act upon their proposals.

The use of fiscal tools for demand management does not necessarily bias the federal budget either to chronically higher deficits or to chronically higher expenditures and taxes. It is true that the budget has been much bigger relative to the economy since World War II than before. This was due to the much larger permanent burdens of national and international security on the United States, and to the growth of social security, Medicare and Medicaid, and other transfer programs. It is also true that the larger size of the budget, given that expenditures are stable or counter-cyclical and tax revenues are procyclical, both strengthened the built-in stabilizers and facilitated discretionary demand management. Until 1981 structural deficits were small, generally less than 1% of potential GNP, and often negative. The public debt grew more slowly than the economy, falling from more than 100% of GNP at the end of World War II to 25% in the 1970s. The size and growth of the budget, expenditures and revenues both, raise political issues regarding the nation's priorities as between various public programs and taxpayers' private interests. Those are quite separate from the uses of fiscal policies as instruments of macroeconomic management, functions that can be performed whether the federal budget is much larger or much smaller than it is today.

Monetary policy as demand management.

Monetary policy, decided and executed by the Federal Reserve System, also operates on aggregate demand --though indirectly, by altering the availability and cost of credit to households, businesses, and state and local governments, by affecting the values of their existing assets and debts, nowadays by influencing the foreign exchange value of the dollar and the competitiveness of American products in world markets, and by influencing the expectations of economic actors about all these variables. In principle, within broad limits, anything that fiscal policy could do to aggregate demand monetary policy could also do, or undo. The two are substitutes for one another in demand management, although their side effects, including their implications for long-run growth of potential output, may be quite different. As policy instruments, they are also substitutes, in the sense that their settings are technically --and in the United States today also administratively and politically-- independent. The Fed is not compelled to print money to finance government deficits; it is free to do the reverse, to monetize less public debt and tighten its policies when fiscal stimulus is strong.

The fact that the two kinds of policies are substitutes has an important implication that is insufficiently appreciated. In doses of equivalent effect on aggregate demand, fiscal and monetary policies have pretty close to identical effects on output relative to prices. The "natural" rate limit to demand expansion remains about the same whether it is approached by monetary stimulus or fiscal stimulus. There is no way to twist the outcome more in favor of output and employment and against price and wage inflation by altering the mixture of monetary and fiscal dosages. In particular, in given circumstances of the economy there is nothing intrinsically more or less inflationary in monetary expansion than in equivalent fiscal stimulus. I will acknowledge one qualification to these propositions below, in discussing international implications of the fiscal-monetary mix, but the central point will stand.

Over the past forty years, particularly over the last fifteen, monetary policy has overtaken fiscal policy as the principal regulator of macroeconomic performance. In the 1940s many Keynesian economists were, because of their reading of experience during the Great Depression, as skeptical of the potency of monetary measures as they were enthusiastic about the newfound potentials of fiscal management of aggregate demand. (They were misreading Keynes, in my opinion.) Until 1951, the Federal Reserve remained a prisoner of its wartime commitment to support federal securities prices at par; essentially there could be no independent monetary policy with interest rates thus frozen. Even after its liberation by the Accord of 1951, the Fed's strategy of "leaning against" the cyclical winds was more a monetary built-in stabilizer than an active control of the economy. In the 1960s, and especially in the 1970s under the influence of monetarist critics, the Fed assumed a more active and independent role. The Fed is, after all, well positioned to be the major arbiter of macroeconomic developments. The Federal Open Market Committee has ten or more moves a year to the Congressional budgetmakers' one.

The decline and fall of compensatory fiscal policy.

In the past forty years discretionary active fiscal policy has fallen in the esteem of both policy-makers and economists. Lags in decision-making and implementation meant that expenditure changes, and even tax and transfer changes, were likely to take effect too late to do their intended good, and might even do harm. New theories, stressing the importance of expectations in the behavior of consumers and business men, questioned the effectiveness of temporary fiscal measures. For example, the temporary income tax surcharges President Johnson belatedly persuaded Congress to pass in 1968 were judged to have disappointingly small effects on taxpayers' spending. The increasing complexity of the annual budget-making process in Congress in the 1970s produced delays that diluted the value of the macroeconomic considerations involved in the decisions. This was unfortunate and ironic, coming at the same time as procedural reforms designed to enhance the rationality of budget-making by requiring Congress to decide consciously on the budget as a whole and by providing members of Congress via its new

Budget Office better independent economic and budgetary intelligence than they ever had before.

At the same time, the grip of monetary policy on the economy was strengthening. As the Federal Reserve drifted towards monetarism and geared its policy to announced targets for growth of monetary aggregates, its policy was leaning much harder against all winds and was less accommodative to fiscal stimuli. The structure of the financial system became more monetarist too. The velocity of money became less responsive to interest rates, for several reasons. When nominal interest rates are high, businesses and households have strong incentives to economize their holdings of cash, irrespective of marginal changes in interest rates. Together with banks, they also have strong incentives to arrange de facto interest payments on their deposits, including transactions accounts. Now previous legal limits on interest payments to depositors are well on the way out.

However, the greatest blow to the use of fiscal policy in demand management came with the Reagan Administration's budgets beginning in 1981. Drastic tax cuts plus rapid build-up of defense spending, incompletely offset by cuts in civilian expenditures, generated deficits, actual and structural, far larger relative to the economy than in any previous peacetime experience. Federal debt rose to more than 40% of GNP in four years.

The Reagan budgetary programs, as they were phased in over several years, were heavy stimuli to aggregate demand during the recovery that began in late 1982. This was counter-cyclical fiscal policy with a vengeance. Of course, it was serendipitous; the Administration officially scorned Keynesian ideas of demand management. The Reagan budgets had two quite different motivations. One was supply-side confidence that cuts in tax rates would tap vast reservoirs of work effort, saving, and enterprise, and thus greatly speed the growth of the economy and even balance the budget. Even if successful, this strategy had more to do with long-run potential GNP than with short-run demand-side recovery. The second was a political strategy designed to achieve the Administration's prime ideological goal, the shrinking of civilian government: Cut taxes, then use the public outcry against the resulting deficits to bludgeon Congress into cutting non-defense spending.

The Gramm-Rudman "solution" to the nation's deficit problem does not restore fiscal policy to effective partnership in demand management. To the contrary, it is likely to be the coup de grace --if it really takes effect, and at least as long as it lasts. Of course, it was already true that the sheer magnitude of the structural deficits ruled out counter-cyclical fiscal policy for all practical purposes; certainly any extra fiscal stimulus to combat recession is now unthinkable. Gramm-Rudman not only formalizes that incapacity but makes matters worse. In case weakness of the economy adds to prospective deficits, the legislation mandates additional expenditure cuts to meet the prescribed schedule for reduction of the deficit (actual, not structural). Such cuts would tend to make the economy weaker still. Thus the built-in fiscal stabilizers that served us well for forty years are to be replaced by mandatory destabilizers. There are, to be sure, some escape hatches in the law, but they are inadequate to prevent the perverse responses just described.

Over the foreseeable future, therefore, Federal Reserve monetary policy will be macroeconomic policy. Without built-in and discretionary fiscal stabilizers, the monetary authorities will have to act more boldly to preserve stability in the face of the inevitable surprises. Fortunately, since its policy shift in 1982, the Fed has become quite pragmatic.

In the 1970s, and especially in the three years after October 1979, the Fed imposed upon itself targets for the growth of intermediate monetary aggregates, M-1, M-2, and so on. Having staked its credibility to the financial markets on the realization of these targets, the Fed was reluctant to deviate from them even when adherence to them had unintended and unwelcome macroeconomic consequences. This dilemma became acute and dangerous in 1982, when an unanticipated and persistent decline in the velocity of money meant that sticking to the targets implied a further severe decline in nominal and real GNP. Eventually Paul Volcker and his colleagues chose the economy over M-1, to univeral relief and with no loss of credibility. That policy shift turned the economy from recession to recovery, and since then Fed policy has been oriented more to macroeconomic performance, as measured by variables that really matter, --GNP, prices, exchange rates, interest rates,-- than to money stock growth targets. The Fed has recognized that velocity is volatile, the more so because of recent institutional, technological, and regulatory changes, and is prepared to adjust money growth to compensate for persistent velocity changes even if it requires transgressing and revising its M targets.

The Fed has, it is true, allowed the economy to stagnate over the last year and a half, but that seems to reflect its macroeconomic judgment rather than its concern for money stock targets _per se_. The corollary is that the Congress should make its own judgments about the desirable paths of real GNP and unemployment, and convey them to the Federal Reserve. After all, these are the most important economic decisions the federal government makes.

Responsible elected officials should not evade them. Twice a year the Federal Reserve reports to Congressional committees its monetary targets for the coming quarters and its "projections" for GNP, prices, and unemployment. Since the Fed has been shifting emphasis to macroeconomic performance and downgrading money stock growth, these projections can be interpreted as its basic targets. The committees should take them seriously in the hearings, both _ex ante_ and _ex post_. (The economy fell short of the Fed's February and July projections for GNP in the second half of 1985.)

The immediate challenge is the transition to a tighter fiscal stance and to a better policy mix. It should not be allowed to bring on recession or prolong stragnation. If fiscal policy is about to be tightened severely, by Gramm-Rudman or by normal legislative process, the Fed should lower interest rates significantly, even if this requires unusually high money growth during the transition. If so, and only if so, will we reap the benefits of an improved mix of fiscal and monetary policy.

The monetary-fiscal mix today and tomorrow.

Reaganomic fiscal policy led to an extreme monetary-fiscal mix, beyond feasible sustainable limits. Even while slack remained in the economy these past three years, the Federal Reserve felt it necessary from time to time to contain the speed of recovery propelled by massive fiscal stimulus. Thus real interest rates, even after-tax rates on U.S. Treasury obligations, which had been elevated sky-high during the Fed's recessionary anti-inflation crusade after 1979-1982, remained above the economy's long-run growth rate after the Fed shifted gears to recovery. This constellation is a recipe for unending and accelerating growth in ratios of federal deficits and debt to GNP. The high net interest costs of the debt alone guarantee such instability, which is of course accentuated by a "primary" deficit (that is, on transactions unrelated to existing debt) of about 2 1/2% of GNP. Although the 40% debt/GNP ratio already reached is not itself disastrous, runaway growth of that ratio is not a viable long-run future.

As I stressed above, the same total dose of demand stimulus can be given in various mixtures of monetary and fiscal medicine. The short-run consequences for output, employment, and prices will be very much the same. Important side effects will be different. The principal differences are in the uses of national output, in particular the relative shares of private and public consumption, on the one hand, and real investment, on the other --to put it more basically, the relative shares of present- and future-oriented economic activities. Generally speaking, a loose-fiscal tight-money policy mix, of which the 1980s present an extreme example, encourages present consumption relative to investment for the future.

I should at this point interject some caveats regarding the identification of future-oriented, growth-oriented, policy with tight budgets. Some deficit-increasing expenditures are future-oriented, for example public investments in infrastructure, research, education, and environmental protection. It would be silly to cut these out in blind ideological belief that only private capital formation matters to the future productivity of the economy. Those outlays should be considered on their merits, weighed against shopping centers and casinos in the private sector as well as against robots and computers. Bob Eisner is right about this, and the JEC could take the lead in insisting on capital accounting for the public sector in the United States, about the only civilized country where it is not done. Moreover, some deficit-increasing tax reductions increase private investment instead of, or along with, private consumption. Careful attention to the content of government budgets is essential to appraise the effects of particular fiscal-monetary mixes. These caveats do not, however, save the United States policy mix of recent years from the charge that it has been pro-consumption and anti-growth.

Comparing the year 1984 with 1978, the last preceding year of normal prosperity, I find that fully 97% of the growth of real final sales (GNP less inventory investment) was destined for private consumption or government purchases of goods and services. The Reagan macro-economic strategy failed completely in its objective of tilting the disposition of national output toward private investment in the interests of speeding up productivity growth. While increased domestic fixed investment did amount to about 23% of the increment of real GNP, this was almost completely offset by the decline in Americans' foreign investment, i.e., our net exports. Domestic capital formation mortgaged to foreigners will not benefit our children and our children's children.

While the tax legislation of 1981 (modified in 1982) gave incentives for private saving and investment, its immediate and direct effect was to add massively to the government's dissaving. The second effect swamped the first. Anyway, there is no evidence that the tax cuts enhanced households' propensity to save. Although new tax incentives may have helped revive business investment in 1983 and 1984 --this too is debatable,-- high real interest rates worked the other way, especially on residential construction, which did not enjoy similar concessions.

The same recovery could have been engineered with much less fiscal stimulus, with deficits in the normal range of postwar experience, and with real interest rates several hundred basis points lower. There would have been more domestic investment and much more foreign investment; we would not have the large trade deficits that have crippled American manufacturing and agriculture.

These international implications of United States macroeconomic policies have been the most surprising and disturbing feature of recent experience. Although they corresponded qualitatively to economists' textbooks, we too were unprepared for their magnitudes. There is a powerful new mechanism by which high interest rates reduce demand for goods and services. It is a product of the regime of floating exchange rates, which replaced the Bretton Woods system of fixed parities in 1971-73, combined with the high international mobility of interest-sensitive funds, free of exchange controls, passing through worldwide markets of marvelous technical efficiency. In the 1980s high U.S. interest attracted funds into dollars, appreciated the exchange value of the dollar, and made American goods uncompetitive at home and abroad. The excess of imports over exports (3% of GNP) has become a major drag on aggregate demand and the source of counterproductive political pressures for protectionism.

At the same time, the dollar prices of goods with unchanged foreign currency prices fell; since these have some weight in American price indexes, the appreciation of the dollar assisted our disinflation -- accounting for perhaps 10% of the decline in the Consumer Price Index from 1980 to 1984. This effect is an exception to the rule I stated above, that for given impact on aggregate demand the mix of outcomes between prices and quantities is independent of the mix of demand management policies. A loose-fiscal tight-money mix does yield somewhat lower prices for the same output. However, this gain accrues only to the one country pursuing the policy. Our trading partners suffered extra temporary inflation because of the appreciation of the dollar, which inflicted on them higher local prices for goods (including oil wherever produced) invoiced in dollars. For the same reason, we will not be able to keep those disinflationary gains of recent years related to the appreciation of our currency. As the dollar depreciates and restores some of our lost competitiveness in world markets, we will have to pay back the disinflation we borrowed from our friends overseas. Consequently, the exception to the rule is not, in may opinion, a weighty justification for the bizarre policy mix the United States drifted into during this decade.

Summary and conclusion.

1. The objectives of the Employment Act should be restored to high priority in federal economic policy. It is high time to break the dismal upward trend of unemployment. The climate is favorable; the stagflationary shocks of the 1970s are behind us. Stagnation at 7% unemployment is over-cautious when no signs of inflationary pressure, either from wage costs or from demand, are visible. So long as these benign conditions obtain, federal demand management policies should aim to reduce gradually the unemployment and excess capacity rates. Under present circumstances, this task falls to Federal Reserve monetary policy.

2. Since 1982 the Fed has been gearing its policies less to money stock targets and more to macroeconomic performance. Its semi-annual projections of GNP can be taken as indicators of its desired path for the economy. Congress should welcome and reinforce this trend, make its own targets for the economy known to the Fed, and hold the Fed responsible for macroeconomic performance, as measured by variables that really matter: GNP growth, prices, unemployment.

3. The inflation-safe unemployment rate, though surely significantly lower than the current rate, can only be estimated with further experience in today's environment, and even then with uncertainty. It is probably too high for the nation's economic health. Structural policies and reforms will be needed to make it possible for demand management policies to aim at lower rates of unemployment. These have to do with government regulations, labor and product markets, wage- and price-setting institutions. The JEC has an opportunity to contribute to the design of such structural changes. The time to fix the roof is when it is not raining.

4. The tight anti-inflationary monetary stance of 1979-82 and the Reaganomic fiscal programs from 1981 on have given the United States an unprecedented, extreme, and bizarre mix of demand management policies. The tight-money/easy-budget combination is not viable in the long run. It results is real interest rates on public debt higher than the sustainable growth rate of the economy. This is a recipe for unending rise in the debt-to-GNP ratio, especially because the primary budget is also in deficit. The policy mix runs counter to long-run growth because it encourages present-oriented uses of GNP relative to future oriented ones. The mix has resulted in a large current account deficit in U.S. international transactions, i.e. in massive net borrowing from the rest of the world. Although the appreciation of the dollar bought us some extra disinflation, it was borrowed from our trading partners and will have to repayed eventually. The temporary disinflationary gains do not justify our policy mix, nor should their reversal deter us from moving to a more normal and better mix or from completing our presently stalled recovery. A tighter-fiscal and easier-money mix will lower interest rates, depreciate the dollar, and improve the competitiveness of American industry and agriculture. It will also be better for long run growth. All these consequences are to be welcomed.

5. Fiscal policy, once the mainstay of demand stabilization, is now the junior partner of monetary policy. The extreme size of current and prospective budget deficits, actual and structural, rule budgetary changes out as countercyclical tools. The Gramm-Rudman remedy is almost worse than the disease, since it mandates perverse pro-cyclical movements in fiscal stimulus. The Federal Reserve will need to be active and bold in order to keep the economy free of recession during the transition to tighter fiscal

policy, a fortiori to complete the recovery and sustain growth.

6. Once the transition is made, there is good reason for optimism that the rest of the century can be one of stability and growth, the more so if pragmatic realism is substituted for ideology in the management of the economy. As an aged veteran soldier of the cause of the Employment Act, I am unavoidably dismayed by the wholesale dismissal on all sides of pre-1980 ideas and policies. I look forward to the day when some of the forgotten "oldie goldies" will be rediscovered and hailed as "new."

Mr. **Silk**. My apologies for being a stern enforcer around here. Draconianism is the order of the day, but I must add that, in this area as in others, wisdom is worth billions of dollars too. So thank you.

Our second speaker is Lester Thurow, the Gordon Y. Billard professor of economics and management at the Massachusetts Institute of Technology. Professor Thurow has also served as a staff economist of the Council of Economic Advisers.

PRESENTATION OF LESTER C. THUROW

Mr. **Thurow**. It seems to me if you look at the Employment Act historically you can argue on one level it's a great success and on another level it's a great failure.

It's a great success because when it was set up the people who set it up really believed that there was some chance that the United States would slip back into the Great Depression. And they saw recessions and depressions as poorly understood beasts that just happened to you and they were looking for a cure. And I think we got a cure and on that level the Employment Act is 100 percent successful.

As Jim Tobin mentioned, I think it is true that at least since the 1961 recession there hasn't been an accidental recession in the United States in a quarter of a century. We've had lots of recessions since then, but each and every one of them was deliberately created either by the administration or by the Federal Reserve Board to fight inflation.

On that level the Employment Act is a dismal failure because we've turned it on its head. Instead of being an act for generating full employment, we have literally made it an act for creating unemployment as a device for fighting inflation, and I suspect the people who wrote the Employment Act 40 years ago never in their wildest nightmares conceived that this would be an act where a government would deliberately set out to create unemployment to cure another problem. If the problem of inflation existed, it should have been cured with some technique other than deliberately having those recessions.

In that sense, I think Jim Tobin is right on. If you are not going to create deliberate recessions in the future you have to rebuild the structure of the economy—to use his metaphor, repair the roof now when it's not leaking—or the next administration, regardless of whether it's Republican or Democrat, is going to create some more recessions to fight inflation and I think that's not the economy we want, and that is the place where the Employment Act has been a complete failure, in the sense that there's been very little imagination and effort put into changing that structural characteristic of the American economy.

Now what my task was today, if you think of the Employment Act, three things are mentioned—full employment, low inflation, and rapid growth. With the exception of a very brief period of time in the late 1950's and early 1960's when Kennedy was campaigning on the missile and the growth gap, very little attention has been paid during this 4-year period of time to rapid growth. All of the attention has been on either full employment or inflation and the assumption was that growth would take care of itself.

Let me suggest to you, if you think about what the Employment Act is going to have to do in the next 15 to 20 years, that you're going to have to make the growth goal first and foremost because that is, in fact, the the problem the American economy is facing and it isn't a phony problem the way the growth gap was a phony problem back there in the late 1950's and early 1960's.

If you look at America's productivity growth rate which is a topic that comes up later in our session this afternoon, you just have to regard it as dismal relative to the rest of the world. The long-run trend rate of growth at the moment of productivity is about 1 percent a year. In 1985 we're going to come in with a productivity growth rate of less than 1 percent.

Now if you think about that either relative to American economic history or relative to what the rest of the world is doing, it's important to understand that although everybody had a slowdown in productivity after the first OPEC oil shock, almost all of the rest of the world has had a complete rebound and is once again having 3 to 4 if not higher rates of growth of productivity in its economy.

Now, I think the problem is that we forgot one of these things that cycles, and that is social organization is important. One of the things the Employment Act was focusing on was social organization. How do you organize America so its economy peforms better? And I think that's a very key thing that you have to think about in this growth problem.

At the moment we have what I call the "lone ranger" philosphy—liberate the entrepreneur and the lone ranger will take care of everything and as a society we don't have to pay attention to those details that, in fact, make for a high growth performance.

Let me just mention several things and I would argue to you that if you really think about the growth component of the Full Employment Act that the Joint Economic Committee is going to have to start worrying about some things that it historically has not worried about in recent years. They are the things we worried about from 1958 to 1962 and we're going to have to put them on the agenda for a long period of time.

For example, basically you can't expect the American economy to have a competitive rate of growth of productivity and a high rate of growth of output if it doesn't have high quality input going into that economy and somebody has to take responsibility to make sure those inputs are in fact high quality.

In the last decade or two decades we have invested half as much as the Japanese in plant and equipment and two-thirds as much as the Europeans in plant and equipment. Now do you really think the American economy can continue investing half to two-thirds what the rest of the world invests? I would suggest to you it can't and therefore you've got to think about those details of social organization, like how do you use consumer credit, how is your tax system set up, that basically gets you at competitive rate of growth of investment.

In theory, you can have competitive investment without competitive saving. You just borrow from the rest of the world and of course that's what we're doing at the moment and I will remind you that we are building a time bomb into the American economy because if we go to 1990 at the current rates and have $1,000 billion of international debt, that will mean we owe interest payments to the rest of the world, which is a hell of a lot more important than owing it to ourselves, of $100 billion a year approximately and that is work of a lot of Americans that is basically going to have to be diverted to paying those foreign debts.

The idea that you should finance the American economy with borrowed money from abroad seems to me like one of those strategies that looks very good in the short run but doesn't look very good in the long run.

Other areas. I think you could go right across the board and look at the inputs into the American economy, what you'll find is that they don't stack up.

For example, if you look at the quality of the work force, you will find that we have 8 percent functional illiteracy rates while the Japanese have one-half of 1 percent. If you look at the number of engineers, you'll find that Germany, France, and Japan are all graduating about 40 percent of their college graduates in engineering and science and we graduate 7 percent.

And you can look at research and development where we are now being outspent and a whole set of other variables.

So I would argue that if you think about where we need to go in the next 15 years that it really is a question of can we put this growth component of the Full Employment Act front and center and not turn basically the Full Employment Act upsidedown and make it a device for having a negative growth. And if you think about what we've done in terms of economic policies in the last 15 years, the Full Employment Act has been used to stop the economy many more times than it's been used to accelerate the economy.

Thank you.

[The complete presentation of Mr. Thurow follows:]

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Joint Economic Committee

Lester C. Thurow
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SUSTAINED ECONOMIC GROWTH

With the advent of Keynesian economics, macro-economics came to be identified with demand management. The reasons for that identification are not hard to find. In depressions or recessions the economic gains to be made from returning to full employment dwarf all other possible economic gains in magnitude. The Great Depression was clearly a demand management problem that required 100 percent of the policy makers' attention. The same perspective legitimately dominated economic thinking in the first two decades after World War II. Frequent recessions (five in number) were the main enemy of economic growth. Productivity was above trend, growing between 3 and 4 percent per year, and the United States enjoyed across-the-board technological leadership.

In the future, however, it will be important not to exclusively identify macro-economics with demand managment. Macro-economics will like binoculars require both a supply and a demand focus.

The Demand Focus

The demand focus will be as important in the future as it was in the past since it is just as impossible now as it was 40 years ago to have a satisfactory growth performance with frequent recessions. But it is important to note that the nature of the anti-recessionary problem has changed. Thirty years ago recessions occurred accidentally and it was the job of the policy maker to prevent those accidents from happening.

The problem of accidental recessions, however, has been cured. There have been no accidental recessions in the U.S. economy since that of 1960-61. Each and every recession since then has been deliberately created to stop inflation. Some of these recessions have occurred later, lasted longer, or been more severe than desired, but none of the last four have been accidents. They have all been deliberately generated by either the Federal Reserve Board or the administration in power.

As a result the nature of the anti-recession problem has fundamentally changed. The key to full employment without recessions is not to be found in demand management but in some alternative to negative demand management — be it a share economy, a social contract, or something else — for curing inflation. To make demand management work requires changes in the micro-economic structure of the economy. With current income setting arrangements, demand management is not a device for achieving full employment, but a device for creating unemployment. If macro-economics is to accomplish what it is supposed to accomplish, it needs different income setting arrangements.

With inflation more or less under control and commodity prices falling inflation is not today's problem, but changes in the micro-economic structure of the economy to make demand management work should be today's problem for the appropriate time for changing the micro-economic parameters of the wage setting system is when inflation is not a problem. Once inflation has again become a problem it will be too late to make the necessary changes.

There is another respect in which the demand management problem has changed. In a very real sense it is the industrial world's supply of money and the industrial world's tax and expenditure policies and not just the American pieces of that total that matter for the American economy. Today it is not just

Americans sitting at the demand management controls of the American economy. When demand management is needed it is going to have to be coordinated with the policies of Germany and Japan if it is to be successful.

This can be clearly seen by thinking about the deficit reduction problem in the United States. If the United States were to cut expenditures or raise taxes to cure its $200 billion deficit without expansionary policies being simultaneously adopted in Germany and Japan, the result would be a massive world-wide recession. Since the world's industrial economies are not now operating at full employment if $200 billion of American demand were to be subtracted from the system, then $200 billion of extra demand would have to be added to the system somewhere else. Thus even American deficits cannot be reduced without foreign cooperation. Americans now live in a world where they are merely part of a larger world economy; a world where they control less than they used to control.

The Supply Focus

The past 15 years have proved that supply does not take care of itself. No one can be satisfied with the economy's per capita growth rate (1.9 percent) or its productivity growth rate (1.5 percent).[1] Such growth rates are unacceptable relative to America's past, relative to the performance of the rest of the industrial world, and more importantly relative to the rate at which American's would like to see their own standards of living grow.

While there are many places were private markets can be liberated to improve performance, a supply focus is not a synonym for laissez faire or lower taxes. In economy theory one can show that laissez faire economies have some desirable properties (they optimally distributed private goods relatively to the initial distribution of income), but a high rate of growth is not one of them.

This is most clearly seen in one of the weak points of the U.S. economy — its low rate of investment and savings.

Given the institutions of the American economy (tax deductibility for consumer and mortgage interest, no or low down payments, long periods for repayment) it may be rational for the average American to take advantage of those institutions and make generous use of consumer and mortgage credit. But if each and every American does so, the net result is a very low aggregate rate of savings. Government at the very least has a responsibility to set the parameters within which people maximize their private utility to yield aggregate results that are consistent with a good long-run economic performance. Free market economies can be organized with or without generous provisions for consumer credit and will have very different performance characteristics depending upon how they are organized. In the end free market economies depend upon the social organization that goes into them.

To accelerate economic growth American needs to make economic growth one of its policy goals. Full employment and low inflation are most often cited as economic goals but it is important to understand that they are only means to an end. The real goal is a high rate of growth in per capita income. While American policy makers take about economic growth, they have not traditionally set growth targets as they have set unemployment of inflation targets. They should start to do so. To set a target is to make something important, but more importantly it is to set a standard of success and failure relative to which the policy makers can and will be judged.

America's growth target should be set relative to the performances of the rest of the industrial world. Basically the United States should have a standard of living that grows in pace with that in the rest of the world. This means that if other leading industrial countries have productivity growth rates in the three to four percent range the United States should aim for a similar result. Given this goal one can then ask what must be done to achieve it.

POLICIES FOR ECONOMIC GROWTH

Growth policies can operate at several levels, but the appropriate place to start is with the quantity and quality of the inputs (capital, labor, technology) going into the economy. In each area the aim should be be inputs as good as those going into the economies of the best of our industrial competitors. Everywhere Americans should aim for world-class inputs.

The Quantity of Capital

Unfortunately American does not now have an economy marked by world-class inputs. American investment in plant and equipment is roughly half that going into the Japanese economy and two-third that going into the economies of Europe. America should aim to bring investment up to the levels of these competitors. An interim target should be set for bringing investment up to European levels and once this is achieved the target should be raised to the level that will make the United States competitive with Japan if Japanese investment is still above that in the United States.

In theory with a world capital market it is not necessary to have a world-class level of savings to have a world-class level of investment. One simply borrows from the rest of the world what is necessary to make the necessary investments. In fact it does not make sense from a national or a world perspective for the United States to be borrowing much of its capital from the rest of the world. Ultimately interest payments on those foreign debts become a drag on the U.S. economy and the world's surplus capital should more appropriately be invested in the developing world and not in the United States.

This means that higher investment rates will in fact require higher savings rates within the United States. In addition to shifting the federal government from being a net dissaver to being a saver, higher savings rates will require changes in tax laws (eliminating the tax deductibility of interest payments) and limitations on consumer and mortgage credit to raise initial down payments and to shorten repayment periods. The American political system seems to be in the process of proving that such changes cannot be sold in the guise of tax reform. It also seems to be proving that it cannot raise taxes as a part of federal deficit reduction.

Whether such changes can be sold as necessary for economic growth remains to be seen. If they cannot, the United States is unlikely to enjoy a world-class rate of growth investing much less than the rest of the industrial world.

The Quality of the Work Force

Ultimately the quality and skills of the work force are a country's only real comparative advantage. As the inventor of mass public education America for many years had the best educated and most skilled work force. But all of the current evidence indicates that the United States now has a work force that does not meet world-class standards when it comes to education and skills.

Eight percent of American youths 14 to 21 years of age test out as functionally illiterate (i.e. they cannot read and write at the 5th grade level).[2] Using slightly tougher definitions of the functional illiteracy, as much as 20 percent of the American work force may be functionally illiterate. In contrast less than 1 percent of the Japanese labor force is functionally illiterate.

When 19 different achievement tests were administered to students in different countries, Americans never ranked first or second, and if comparisons are limited to other developed nations only, the U.S. ranked at the bottom seven out of nineteen times. Mean scores placed American in the bottom half of the rank-order distribution thirteen times and in the top half only six times.[3] In an international study of mathematics ability for 8th and 12th graders, the 8th graders ranked in the bottom tenth internationally and the 12th graders were 'markedly lower' than the international average in all seven of the areas tested.[4]

Those are unacceptable results that must be altered. Education may be a state responsibility, but no national government can for long tolerate an education system that is not generating a competitive work force.

If one looks for the reasons for a poor American performance, one factor stands out. The United States has a much shorter school day and school year than most of the rest of the industrial world. Students go to school 240 in Japan and 220 days in Sweden. In contrast American students are in school only 180 days. Americans cannot learn in 180 days what it takes the rest of the world 220 to 240 days to learn.

To lengthen the school year half of federal educational aid should be conditioned on a longer school year. The other half should be conditioned on a school's achievement test scores relative to what one would have expected from the historical norms for schools with students of the same socio-economic background. If one does well on performance measures relative to schools with similar student inputs, one gets more federal aid than if one does poorly relative to similar schools.

If the federal government can set standards for Interstate Highways if a state wants federal highway money, it can set standards for eduational inputs and outputs if a state wants federal education money. When it comes to that famous bottom line a well educated work force is much more important to national economic success than a good highway system.

If one looks at the U.S. education system there is a major gap. No training system exists for the training of the non-college bound. Germany fills this gap with an elaborate system of publically financed but privately run apprenticeship training and private firms provide such training in Japan. American has no general system of publically financed training for the non-college bound and because of high labor force turnover rates, private firms find that it is not in their immediate self-interest to pay for the extensive training of workers who are unlikely to remain on their payrolls.

Such a gap is both inefficient (the economy has a perpetual shortage of skilled non-college workers) and unfair (the average American college student gets a public subsidy of $12,000 over the life of his college career). It is a gap that must be closed. Individual training accounts are one possible answer, but some answer must be adopted if the U.S. is to grow rapidly in the future. In the past the United States could count on immigration (principally from German and Austria) to provide skilled blue collar workers but now that real standards of living are have essentially reached parity in northern Europe that source of supply has essentially ended.

Maintaining Technological Parity

In the last few decades Americans have relied on superior technology to offset other handicaps. American may not have had the best labor force or the newest capital, but it had the best technology and many goods were only be had from American sources. But that era is now gone. The rest of the world has caught up with the United States technologically and few if any goods are only to be had from U.S. sources. While it is impossible for the United States to go back to the effortless technological superiority that it had in the 1950s (it was a product of the human and physical destruction of World War II), it is important that the United States maintain civilian technological parity.

While the United States is not yet generally behind technologically, it is clear that there is a technological problem. Process technology is a clear American weakness. In too many leading industries American firms are operating with inferior processes. Foreign firms could pay the same wages and still sell below American costs. Expenditures on civilian R&D as a fraction of the GNP are now below those in Japan, German, and France.[5] Both Japan and Germany graduate about 40 percent of their college students in science and technology while less than 10 percent of American students graduate with engineering or science degrees.[6] In addition 40 percent of America's scientific personnel is envolved in defense work.[7]

It is interesting to note that in the decade of the man-on-the-moon effort, the United States thought that it was necessary to have programs for augmenting the supply of scientific manpower so that the demands of the space efforts did not cripple domestic industries. Yet in the 1980s with a much bigger build-up underway in the defense department no similar efforts are being made to increase the supplies of scientific manpower.

In reality America will need a similar intensification of scientific effort in the 1980s if it is to enjoy a competitive rate of growth. This intensification of effort is not going to occur automatically. In a closed economy a shortage of engineers would lead to higher wages for engineers and in the long-run a larger supply of engineers. Given the high costs of scientific education, however, even in a closed economy it should be emphasized that the long-run might be very long and that for this reason the man-on-the-moon effort did not rely on automatic market mechanisms to cure potential shortages of scientific personnel.

In an open economy a shortage of engineers need not lead to more engineers even in the long-run. Those industries that are engineering intensive simply move to those countries that have an adequate supply of engineers. If one looks at the industries that are now moving abroad (machine tools, electronics) it is perhaps not an accident that these are precisely those industries that are intensive users of technical personnel.

Taxes and High Quality Inputs

In maintaining technological, labor force, and capital parity, the main problems are not those of what must be done or how should it be done, but in politically deciding that something must be done if the United States is to enjoy a competitive rate of growth. 'Cut taxes' or 'do nothing' are the current winners when it comes to public policy prescriptions.

At the moment the federal budget deficit is usually advance as the main reason as to why it is impossible for the United States to undertake any new federal expenditure programs. Yet both a skilled labor force and technological parity are realistically going to require some new expenditures programs. Perhaps it is well to point out that with Japan having just passed the United States it is now true that all of the major developed nations pay a larger fraction of their GNP in taxes than the United States. The United States is not an over-taxed society. It is in fact an under-taxed society.

To be a nation with the world's lowest industrial tax rate is not a desirable goal if achieving that goals means an economy that cannot generate a competitive rate of growth. At some point Americans will have to face the fact that higher taxes will be necessary to have a competitive economy.

If the Federal government is to shift from being a net dissaver to being a net saver (and it must if savings rates are to increase), higher taxes will be necessary. If the United States is to have a labor force with skills second to none, higher taxes will be necessary at some level of government to pay for a better education system. If the American economy is to maintain its technological base, it is going to have to pay higher taxes since research and development expenditures are everywhere paid for by government. The externalities are simply too great to rely on private markets to generate adequate research and development efforts.

If higher taxes are politically impossible, then it is impossible for the United States to have a competitive growth rate for it cannot grow at competitive rates investing less, employing a less killed labor force, and working with inferior technology.

Implicitly Americans are now assuming that if they are willing to play a free market game they will automatically be winners of that game. Yet no such outcome is guaranteed. There will be winners but they need not be American. Economic growth requires social organization. Those economies with rapid rates of growth of productivity are those that pay attention to good social organization.

THE GAME PLAN

The winners in economics as well as in sports are those who play with the best inputs but what about the game plan — America's economic strategy for success. In the past America has not relied solely on its private firms to guarantee economic success. America's first great process invention, interchangeable parts, was financed with money from the War Department. The railroads were financed with grants and loans from the government. The steel industry developed behind trade barriers that kept cheap British steel out of America during the railroad building era. America's advantage in agricultural productivity can be traced to government programs such as its agricultural colleges, its extension service, its reclamation projects, its electrification programs, and a plethora of financial institutions that made it possible for farmers to mechanize. The civilian aviation industry is a by-product of defense spending. Historically the American government has often intervened at strategic points to improve economic performance.

If the managers of any large American company operated without a strategic plan, they would be considered derelict in their duties. Yet because strategic thinking has been equated with economic planning in the socialistic sense American policy makers publically maintain that the American economy does not need a strategy vis-a-vis its international competitors. Yet if one looks at America's principle economic competitors — Germany, Japan — they each undertake some form of strategic planning. Outside observers argue as to how much of their success can be traced to their strategic planning and how much can be traced to other factors, but it is interesting to note that both think that such strategic thinking is useful.

In the past these strategies have most often been implemented with government investment banking or with governmental allocation of scarce foreign exchange, but in the present foreign strategies seem to be operating primarily at the level of research and development. Just as the American government has picked SDI as a target area for defense research so have foreign government picked various civilian industries (electronics, new materials, biotechnology) as target areas for industrial research.

If one wants to look at the impact of such foreign policies one need only look at the current plight of the American semiconductor industry.8 Starting first with a governmentally financed research effort to leapfrog American technology and develop large (64K RAM and up) chips but continuing with a designated and limited set of producers, quasi-protected home markets and production loans that did not have to pay interest or principle until and unless profits were earned, Japan has succeeded in capturing more than 90 perent of the market for 256K RAM chips and may have prevented any American firms from attempting to build the megachip (1000K RAM). Yet semiconductor chips are the building blocks for the rest of electronics. It is difficult to believe that an industry can ultimately be competitive when it cannot competitively build its own basic ingredients. Consumer electronics has been captured by foreign producers and the same trend is now visible in the rapidly diminishing competitiveness of American industrial electronics products.

Germany has announced similar efforts in the new materials industry (powdered metals, metal ceramics, pressed graphites, etc.) that is now emerging. It is too early to say whether they will be as successful in materials as the Japanese have been in semiconductor chips, but no one should discount their effort.

If one looks at America mounting trade deficit in research and development intensive products, one has to be a little concerned whether the United States is going to be able to maintain its traditional position in leading edge new industries. Current trends are not running in the American direction.

Japanese strategic planning is coordinated by a government agency (MITI) while German strategic planning is coordinated by the large private investment banks, but in both countries government and industry meet to formulate a strategy to increase economic growth and to maximize international competitiveness. America need not organize itself as either Germany or Japan is organized, but it needs some forum for doing what is being done abroad.

Americans often think that private American firms will do whatever strategic planning is necessary for the American economy to be successful and that as a result govenrment has no role to play. Private firms simply will not do what is necessary. In a very real sense there are no private American firms. There are firms legally headquartered in America but they can locate their research and development, office or production facilities anywhere in the world. Per se they have no direct company interest in the success or failure of the U.S. economy. They only have a direct interest only in their own success and failure. Often it is cheaper for an Amerian based company to simply move production or engineering abroad than it is for it to make its American operations competitive. Yet foreign production is not a solution to American growth problems even if it is a solution to the competitive problems of American based companies. If economic strategies are necessary for the United States to be successful in world markets they are going to have to be developed with the impetus of government leadership or they will not be developed.

While government has to be an organizational catalyst for strategic planning the plans have to be developed and implemented with the cooperation of private industry and labor. Only they know what must be known to chart the correct directions of movement. Once formulated only they can implement. But to bring the interest parties together in a serious way some some locus of decision making authority must exist. Historically government investment banking has played this role. A key missing ingredient has often been capital and industry automatically takes a potential source of funds seriously. Bankers, government or private, can demand information before making loans.

Since such a government banking vehicle raises political hackles and may in any case not be the currently appropriate vehicle for strategic planning, let me suggest that American strategic planning should take place in a government funding institution for industrial research. The federal government should set up a research and development institution for industry similar to the National Science Foundation that now exists for basic (mostly university based) research and development. Just for the sake of a title let me call the agency the National Industrial Research Foundation or NIRF.

This institution should be separate from the NSF since stimulating industrial research is fundamentally different from paying for basic research and development. In all cases firms would be expected to play a leading role in formulating the target areas for research, always be expected to contribute part of the funds and help organize cooperative efforts with other firms, and have priority rights to the products and processes that were developed. Since the agency must have an interest in process research (making old products cheaper) and since process research can only be developed and tested in the context of actual production the agency will be interested in a level of research and development that is now far outside of the scope or expertise of the NSF. With government funds envolved, the government would also insist that technologies developed in cooperation with the agency could only be used in the United States for some period of time, say 5 years. Government would also expect to earn its share of the profits on products and processes that were successful. Government money is not a grant but a contigent investment that will be repayed with a share of the profits if the investment is succesful.

In many ways NIRF would be doing for civilian industry what the Defense Department now does for defense industries.

Of necessity an industrial research agenda can only be formulated in the context of information on a more general set of economic parameters. As a result the need to formulate an industrial research strategy would automatically lead to discussions on more general economic strategies.

Conclusion

To maximize the macro-economic parameter of economic growth requires changes in the micro-economic structure of the American economy on both the demand and supply side of the equation. Frequent recessions can only be avoided if alternative means of fighting inflation are developed and if the principle industrial governments can coordinate their demand management policies be they fiscal or monetary.

On the supply side of the equation the general quantity and quality of the fundamental inputs going into the economy has to be of national concern. Local school districts are not going to solve the aggregate problem of creating a world-class labor force. Since each district's contribution to that result is vanishingly small and each district can imagine itself hiring skilled personnel from elsewhere in the economy, every local district has an incentive to under-invest in eduction. Yet if each district does so the end result is an American disaster. Similarly each individual finds it rational to take full advantage of the current generous provisions for consumer and mortgage lending and each company finds it rational to cut-back on general research and development expenditures. Yet if each does what it is individually rational to do the general result is social irrationality and an economy that does not perform as it should perform.

In economics social organization matters and government has to take responsibility for insuring that America's social organization is second to none. If it is to do its thing free enterprise needs the right operating context. Without that context it can only fail.

Footnotes

1. Council of Economic Advisers, Economic Report of the President, 1985, pages 234 and 278. Council of Economic Advisers, Economic Indicators, Nov 1985, pages 2 and 16.

2. Gene Maeroff, "Task Force Reports 8 percent of City Youths are Illiterate", New York Times, April 7, 1982

3. Barbara Lerner, "American Education: How are we doing?" Public Interest, #69 Fall 1982, page 64.

4. Edward B. Fiske, "American Students Score Average or Below in Internatonal Math Exams," New York Times, Sept. 23, 1984, page 30.

4. National Science Foundation, National Patterns of Science and Technological Resources, 1982, page 33. IP # 12

5. National Science Board, Science Indicators, 1982, 1983, page 22.

7. Charles L Schultze, "Economic Effects of the Defense Budget" Brookings Bulletin, Fall 1982.

8. David E. Sanger, "Pushing America Out of Chips" June 16, 1985, page 1 Section 3.

Mr. Silk. Thank you.

I would like to remind the members of the audience that they can offer questions to the panel by holding up their hands to get a card for that purpose and in due course having somebody pick up the card.

Our third speaker this morning is Herbert Stein, who is a senior fellow at the American Enterprise Institute and the editor of the AEI Economist. Dr. Stein served as chairman of the Council of Economic Advisers and is presently a member of the President's Economic Policy Advisory Board.

PRESENTATION OF HERBERT STEIN

Mr. Stein. Thank you, Leonard.

First, since it's important to what I have to say, I would like to remind my young friend that the act we are now celebrating is not the Full Employment Act. After many months of debate on this precise subject, the word full was excised from the legislation. We have the Employment Act of 1946. We have a subsequent Full Employment and Balanced Growth Act of 1978 which nobody has yet thought to celebrate.

Also, it's important for me to say that this Act does not contain the word growth in it anyplace. I was here at the time and I do not recollect that the term growth ever came up in the discussion. I want to emphasize that I'm talking about growth as distinguished from high employment or full employment or the level of output that you do get at high employment automatically. I'm talking about the problem of growth as a problem of increasing the level of output that you get when you have high employment or full employment.

Since the management is being very strict with the clock, I'm going to start with my conclusion to make sure that I get it in, and the conclusion is a repetition if a paragraph that Edward Denison and I wrote 25 years ago. At that time, in 1959, President Eisenhower set up a commission on national goals and Ed Denison and I were asked to write a report on high employment and economic growth. With respect to growth, after a good deal of arithmetical work which Ed Denison supplied, we said:

> * * * Any goal is proposed at the expense of others that are or might have been advanced, and the cost of elevating accelerated economic growth to the front rank of goals is that something else is deprived of that position. The number of goals calling for our attention is large—to help set the underdeveloped world on the path of economic progress, to reduce the barriers of nationalism and racialism, to strengthen our national security, to improve the lives we lead with our immense flow of goods and services, to set a floor of economic security and welfare for all. We need not feel guilty of negativism or passivity if we decide that accelerating growth is not one of our most critical needs.

As I've said, the Employment Act of 1946 does not mention growth. It talks about maximum production as a corrollary of maximum employment which itself had a particular meaning.

The great attractiveness of the goals in the Employment Act of 1946 was that they seemed to be free. All that was required was to create conditions in which people could do what they wanted to do. The necessary condition was adequacy of total demand which could be created primarily by an expansive fiscal policy, giving the public more government benefits or taking less taxes. No one had to sacrifice anything except old dogmas like the idea of a balanced budget.

Growth in the sense in which I use it here will not be realized without significance cost. It is not free. Moreover, there is no general theory for achieving it by the manipulation of one or two variables.

Since 1981, we have had an experiment with the theory that economic growth could be achieved free by the manipulation of one or at most two variables. The variables are taxes and possibly also government expenditures, and the necessary manipulation consists of reducing them. The experiment began with the 1981 tax cut. The experiment is not over and disputes about its lessons will surely continue for a long time. Nevertheless, the experience is suggestive. The rise of total output over the 5-year period from 1980 to 1985 was not exceptionally large. In fact, it was less than in any 5-year period ending between 1962 and 1980; except for 1975 in the postwar period.

Disentangling the trend of productivity growth from its cyclical behavior is difficult but the best estimate is that the trend of productivity growth has not increased. Revenue has not increased enough to prevent the emergence of a large deficit relative to GNP in peacetime history.

The ratio of net private savings to GNP is about the same as its average in the 1960's and 1970's. There is no evidence that the tax change designed to increase the after-tax return to savings has increased the propensity to save.

The idea that the existence of a budget deficit with the implication of higher future tax burdens would by itself raise the private savings rate has not been borne out.

All of the foregoing confirm the expectations of conventional economics. The only surprise was that despite the increase in the deficit and a failure of the private savings rate to rise, the rate of net domestic private investment as a reaction of GNP in 1984 was almost as high as in the 1970's. The explantion was the exceptionally large capital inflow from abroad which financed the difference between the unchanged private investment rate and the reduced rate of domestic private savings available for private investment.

In 1980, enthusiasts for tax reduction as the route to economic growth pointed to the example of Puerto Rico. Skeptics, including me, replied that there was a vast difference between a small island that could import large amounts of capital from the rest of the world and the United States that was half of the world economy. But it turned out that the United States could be much more like Puerto Rico than anyone had expected.

Up to this point it would appear that the experiment of tax reduction to promote growth had not succeeded and, indeed, except for the capital inflow, had a negative effect. But even when account is taken of the capital inflow the effect seems to have been negative, if our interest is in the real incomes of Americans, because at least part of the income generated by the capital inflow will not belong to Americans.

The point is often made that the 1981 tax cut would have yielded the promised benefits in more investment and growth if expenditure had also been cut so that the deficit would not have risen so much.

Merely to say that private investment will be higher the lower government expenditures are, given the tax rate, does not say that a reduction of Government expenditures will increase growth. Everything depends on what the Government expenditures are for. A leading example today is defense expenditure. The common assumption that cutting defense expenditures would increase growth derives from a short-sighted view because it ignores the possible effects on economic growth that would follow from failure to defend the country. Suppose, for example, that cutting the annual defense budget by $100 billion and getting all of that amount added to business investment would increase the annual growth rate, in peacetime, by 0.3 percentage points—say from 3.0 to 3.3 percent. Suppose also that cutting the annual defense budget would reduce by 10 percent the probability of surviving any year after 2000 without a nuclear war. One would require an extraordinarily high rate of discount to conclude that cutting the defense budget would increase economic growth. And of course, similar points can be made about things that are more conventionally considered as pro-growth expenditures such as expenditures for education, research, roads, and so on.

The only point of all this is that growth in the sense in which I'm using it is not free. It has its cost. We are a very rich country with very high standards of living and have a lot of other problems to solve and I would like to enter a disclaimer against the common practice these days of putting economic growth at the head of the list of our economic or national objectives. Thank you.

[The complete presentation of Mr. Stein follows:]

Herbert Stein
January 9, 1986

ECONOMIC GROWTH AS AN OBJECTIVE OF NATIONAL POLICY

Probably I am not the right person to be contributing an essay on economic growth for the 40th Anniversary of the Employment Act of 1946. I do not think that there is much that the government can do to accelerate economic growth, or at least not much that we know with confidence would have that effect without substantial costs. And I do not think that the acceleration of economic growth is so important an objective for the United States that any great cost should be paid to achieve it. But in popular discussion these days the assumption is common that growth is the paramount economic objective, if not the paramount national objective of any kind, and assertions that there is a clear and sure way to get more growth--usually meaning less taxes and less government spending--are also common. A certain degree of skepticism or agnosticism on these matters may be healthful.

The Employment Act of 1946 does not mention economic growth. My recollection of the discussion leading up to the act is that the matter of economic growth did not come up; certainly it was not prominent in the discussion. The Act does, of course, specify the objective of "maximum production" along with maximum employment and maximum purchasing power. The reference to production might be thought to be an intimation of what we would now call the growth objective, but I think that would be incorrect. "Maximum production" in the Act should be thought of as a corollary to "maximum employment," which itself had a particular meaning, if not an explicit one.

In the discussion of the bill, which was originally called "The Full Employment Act", the point was made that if the word "full" was taken literally all the women and children would be required to take jobs. Of course, that was not the objective of the bill. The objective was to end involuntary unemployment. "Full" employment, changed in the final act to "maximum" employment, meant that everyone who wanted to work at a wage not in excess of the value of his product should be employed.

Maximum production in the 1946 Act meant the production that would occur when there was maximum employment. The policy to achieve maximum production would be the policy to achieve maximum employment. Nothing in the Act called for any different policy to raise the level or rate of increase of production per employed worker.

The great attractiveness of these employment and production objectives was that they seemed to be free. All that was required was to create conditions in which people could do what they wanted to do. The necessary condition was adequacy of total demand, which could be created primarily by an expansive fiscal policy--giving the public more government benefits and taking less taxes. No one had to sacrifice anything except old dogmas like the idea of the balanced budget.

What I shall mean here by growth is a durable increase of total output beyond that which is the natural and effortless accompaniment of the achievement of "maximum employment". Unlike the goal of the original employment act the goal of increasing growth will not be realized without significant cost. This is not free. Moreover, there is no general theory of achieving it by the manipulation of one or two variables.

Of course, we knew at the time of the Employment Act of 1946 that there was such a thing as economic growth, and that much of economic analysis and history was about that. We were also beginning to get our first good comprehensive measures of it with the GNP data. But we didn't think economic growth was a problem, at least for the United States. In the 1947 policy statement of the CED, "Taxes and the Budget", on which I worked, there is a little section on the relation between economic growth and fiscal policy. But the section was not about how to achieve more economic growth through fiscal policy. It was about how to adapt fiscal policy to the fact of economic growth which we believed was given and no problem. At that time, in the decade after the war, economic growth was a problem, and an important object of national policy, for the less developed countries and perhaps even for Europe, but not for us.

About 10 years after the Employment Act of 1946 economic growth in the United States began to appear as a proper object of policy in the United States. This was partly because the prevention of mass unemployment, the real concern of 1946, no longer seemed a problem and policy-makers, in office or aspiring, needed new worlds to conquer and new promises to make. Also, we were seeing that other countries, some enemies and some friends, were growing more rapidly than we, which worried and challenged us.

Much of what passed for pro-growth policy in the 1960s was simply policy to speed up the growth of aggregate demand in the belief that the result would be a lower level of unemployment and consequently more output. It was essentially policy to implement more vigorously the mandate of the 1946 Act. But also other kinds of proposals were advanced, and some adopted, in the name of economic growth. Rather similar lists of measures could be found in a 1958 policy statement of the Committee for Economic Development, the section on economic growth of the Commission on National Goals set up by President Eisenhower in 1959 and various annual reports of the Council of Economic Advisers, before and after 1960. These measures were generally of two kinds. The most common, and most relied-upon, were measures to increase investment of several kinds--in education, in research and development, in public infrastructure and in business plant and equipment. As can be seen, the concept of investment in those years was fairly comprehensive, and not confined, as it has become more recently, to investment by private business. One idea of that period which has a particular relevance, and poignancy, today was the suggestion identified with the name of James Tobin that growth should be promoted by running a budget surplus that would add to the funds available for private investment. Typically, little attention was paid to the source of the private saving or public surplus that would be needed to finance these investments, which is to say that little attention was paid to the cost of the additional investment.

The other kind of measure commonly recommended was the improvement of efficiency by steps to perfect markets. This included suggestions to reduce tariff barriers, reduce regulations and reduce subsidies. Such actions also would involve costs for those previously protected or subsidized.

The Kennedy-Johnson tax cut enacted in 1964 is commonly cited--usually by Republicans--as a leading and successful example of an action to promote growth. That episode is, however, difficult to interpret. The tax cut did include some measures of a kind now usually described as pro-growth--specifically the reduction of effective tax rates on business investment. Whether growth in the sense of something more that a reduction of unemployment by the stimulation of demand was an objective of the provisions of the act, or whether they were intended only to pump up demand and simultaneously mollify the business community is unclear. Interestingly, the act did not include any pro-saving measures. The investment that the act would stimulate was considered to be self-financing, and therefore "free" because the act would raise the national income enough to generate enough additional private savings and reduction of budget deficit to pay for the investment.

Reference to economic growth as an object of national policy was submerged from about 1965 to 1975 by concern with the Vietnam War, inflation, price control and the energy crisis. But in the middle-1970s the growth flag was raised again for two quite different purposes and from two quite different sources. One of these movements came from the more liberal wing of the Democratic Party and culminated in the "Full Employment and Growth Act of 1978." The motivation here was to complete the limited victory achieved by the Employment Act of 1946 by moving beyond the avoidance of mass, involuntary unemployment to "Full Employment"--the term specifically rejected in 1946. Full employment had a numerical definition--the adult unemployment rate should not exceed 3 percent. But the interesting thing is that by 1975 or so one could not put up the flag of full employment without attaching the word "growth" to it, even if that had to be qualified by the word "balanced" to show that it was not meant in a hard-hearted Darwinian sense but in some more compassionate sense. But even the addition of the goal "balanced growth" was not sufficient to launder the claim to "full employment." The Act specified a great many other goals to assure that no one could take offense--"a balanced Federal budget, adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance through increased exports and improvement in the international competitiveness of agriculture, business, and industry, and reasonable price stability." The proliferation of goals needed to get the act adopted did not make the act meaningful; it only showed that by saying everything the act said nothing. The authors of the act thought to repeat the success of the Employment Act of 1946. But the 1946 Act, although a symbol, was a symbol of a real thing--a new national priority and a new approach to serving it. The 1978 Act was only a symbol. After seven years the Act has had no consequences, and is only worth mentioning as an example of the use of "Growth" as a presumably acceptable symbol.

The other pro-growth movement that began in the mid-1970s had more consequences. That was the movement which began with the assertion that the United States was suffering from a shortage of capital which could be corrected by a reduction of tax rates on the return to capital. This idea was most promoted by the business and financial community but had support in other quarters as well. The idea has a certain limited influence on tax policy in 1978, notably in the reduction of the tax rate on capital gains. But it only became politically irresistible and fully implemented when the proposed tax reduction was broadened to apply to all income taxes and not only to taxes on the return to capital. Since that happened in 1980 pro-growth policy in discussion and action has been tax policy--first tax reduction and later tax reform.

The connection with growth was essential to the argument for tax reduction in 1980 and 1981, and continues to be essential to the argument against tax increase now. The claim that tax reduction would substantially raise economic growth was necessary to show that what was sought was more than relief for taxpayers--more-or-less in proportion to their taxes. Economic growth was the national objective to be served, from which everyone would benefit. But the expectation of rapid economic growth as a result of the tax cut was necessary to make the strategy plausible. The rapid growth would generate enough additional revenue plus enough additional private saving to offset the loss of revenue caused directly by the tax cut, so that the supply of saving available to finance private investment would be increased, rather than decreased. Otherwise it would be hard to see where the economic growth would come from. Thus, the prediction that the increase of growth would be very large was necessary to support the claim that there would be any increase of growth at all. If the increase of growth was small there would be an enlarged budget deficit that would defeat the growth by suppressing private investment. Moreover, unlike the argument for the 1964 tax cut, this had to be an increase of growth, not merely the achievement of high employment that could be reached by "Keynesian" means. The argument was about increasing the level and growth rate of the output that would be realized at high employment.

In the past five years there has been an experiment testing the connection between tax rates and economic growth. The experiment did not satisfy scientific experimental requirements, the experiment is not over, and dispute about its lessons will surely continue for a long time. Nevertheless the experience is suggestive.

The 1981 tax cut was one of the largest, possibly the largest, in history. It emphasized reduction of marginal rates in all income tax brackets, acceleration of depreciation allowances and enlargement of the tax credit for business investment. Since this happened, the following developments, or lack of development, have been observed.

1. The rise of total output over the five year period from 1980 to 1985 was not exceptionally large; in fact, it was less than in any 5 year period ending before 1980. The rise of total output from 1982 to 1985 was unusually strong, but that was from an unusually low point. There is no evidence of any increase in the rate of non-cyclical growth.

2. Disentangling the trend of productivity growth from its cyclical behavior is difficult, but the best estimate is that the trend of productivity growth has not increased.

3. Revenue has not increased enough to prevent the emergence of the largest deficit, relative to GNP, in peace time history.

4. The ratio of net private saving to GNP is about the same as its average in the 1960s and 1970s. There is no evidence that the tax changes

designed to increase the after-tax return to saving have increased the propensity to save. The idea that the existence of a budget deficit, with the implication of higher future tax burdens, would by itself raise the private saving rate has not been borne out.

5. All of the foregoing confirmed the expectations of conventional economics. The only surprise was that despite the increase in the deficit and the failure of the private savings rate to rise, the rate of net domestic private investment by 1984 was almost as high as in the 1970s. The explanation was the exceptionally large capital inflow from abroad which financed the difference between the unchanged private investment rate and the reduced rate of domestic private savings available for private investment. (See Table, p. 8a.) enthusiasts for tax reduction as the route to economic growth pointed to the example of Puerto Rico. Skeptics replied that there was a vast difference between a small island that could import large amounts of capital from the rest of the world and the United States that was half of the world economy. But it turned out that the United States could be much more like Puerto Rico than anyone had expected.

Up to this point it would appear that the experiment of tax reduction to promote growth had not succeeded and indeed, except for the capital inflow, had a negative effect. But even when account is taken of the capital inflow the effect seems to have been negative, if our interest is in the real incomes of Americans, because at least part of the income generated by the capital inflow will not belong to Americans. Probably the capital inflow generated some income for Americans, by increasing the productivity of American workers and in other ways. If the capital inflow does not exceed the deficit, however, the net effect to the tax reduction on American real incomes is negative.

Net Savings and Investment

Percent of GNP

	1960-69	1970-79	1984	3 Quarters of 1985
Net Savings Available to Finance Private Investment	7.0	6.3	6.6	5.7
Private Saving	7.8	7.2	7.4	6.3
Federal Surplus	-0.3	-1.8	-4.8	-5.0
State and Local Surplus	0	0.8	1.4	1.3
Foreign Capital Inflow	-0.5	0.1	2.6	3.1
Net Private Investment	7.0	6.4	6.4	5.5
Statistical Discrepancy	0	-0.1	0.2	0.2

This line of thinking suggests that a tax change that has a large effect of attracting capital to the United States and only a small effect of the U.S. budget deficit could increase the real incomes of Americans. A reduction in the tax on the return to capital and an increase in other taxes could have this effect--for one country. Every country can not be Puerto Rico.

The apparent failure of the 1981 tax cut to generate more investment and more growth is sometimes blamed on this failure, even by 1985, to reach "full employment," which is presumably due to inadequate monetary expansion. The argument is that at full employment today revenues would be higher, the deficit smaller or zero, available savings higher and domestically-owned investments higher. This may all be true, although the increase in the money supply in the past five years has been extraordinarily great and whether we are now below full employment is uncertain. But even if true the argument does not relate to the subject of this essay. Our question is whether the level of output or rate of growth of output at full employment is raised by cutting taxes. On this question the experience of the past five years gives a negative answer. That is, nothing in that experience contradicts the common-sense view that total revenue or total revenue plus saving will be lower, at any level of output, the lower tax rates are. In that case, and abstracting from the capital inflow, one can also say that the level of private investment will be lower the lower tax rates are, given the level of government spending.

The point is also often made that the 1981 tax cut would have yielded the promised benefits in more investment and growth if expenditure had also been cut, so that the deficit would not have risen so much. This may or may not tell us something about the growth effect of cutting expenditure. It does not tell us anything about the growth effect of cutting taxes.

For example, expenditure rose from 22.6 percent of GNP in 1980 to 23.5 percent in 1984. Suppose that expenditures had been held at 22.6 percent. The question is whether, given that expenditure level, investment would have been higher in 1984 if receipts had been kept at 20.3 percent of GNP rather than reduced to 18.6 percent. The deficit would have been smaller by 1.7 percent of GNP, and given the unresponsiveness of savings to the tax rate, as I see it, investment would have been higher with the higher tax rates.

Merely to say that private investment will be higher, the lower government expenditures are, given the tax rate, does not say that a reduction of government expenditures will increase growth. Everything depends on what the government expenditures are for. A leading example today is defense expenditure. The common assumption that cutting defense expenditures would increase growth derives from a short-sighted view, because it ignores the possible effects on economic growth that would follow from failure to defend the country. Suppose, for example, that cutting the annual defense budget by $100 billion and getting all of that amount added to business investment would increase the annual growth rate, in peacetime, by 0.3 percentage points--say from 3.0 to 3.3 percent. Suppose also that cutting the annual defense budget would reduce by 10 percent the probability of surviving any year after 2000 without a nuclear war. One would require an extraordinarily high rate of discount to conclude that cutting the defense budget would increase economic growth--and there is more to life, of course, than economic growth. I am not suggesting that these are the correct numbers, but only that some such calculation and judgment is required for a decision about expenditures. A similar point must be made about government expenditures more conventionally considered "pro-growth"--such as expenditures for education, research, roads, ports and so on. Every expenditure put in one of these categories in the budget does not necessarily promote growth. But many of them do, and discrimination is required in equating expenditure-cutting with growth-stimulating.

On this whole subject of the relation of government spending and taxing to economic growth some calculations I recently made are provocative:

> ...one dimensional explanations of growth and approaches to the increase of growth are almost certainly wrong. The leading case today is the view that government spending and government taxing are the enemies of growth and that the sure and sufficient way to get more growth is to cut expenditures and revenues relative to GNP. Looking at American history is instructive at this point. In the thirty-seven years from 1948 to 1985, Federal expenditures have averaged around 20 percent of GNP and Federal revenues around 18.5 percent. In the thirty-seven years from 1892 to 1929, Federal expenditures were around 4.5 percent of GNP and revenues around 3.5 percent. (Most of the difference was run up in World War 1.) In the early, small-government period, real GNP rose at an annual rate of 3.4 percent. In the later big-government period, real GNP also grew at an annual rate of 3.4 percent. In the small-government period output per worker-hour rose by 1.5 percent per annum; in the big-government period, it rose by 2.3 percent per annum. These figures are not meant to demonstrate that big government is good for growth; and, of course, one must consider the consequences of big government for values other than growth. These simple facts do suggest, however, that the truth is much more complicated than it is often claimed to be.[1]

One can, of course, think of expenditure cuts that would probably increase economic growth. This would probably be wxyz, for example, of cutting expenditures for agricultural aid, Amtrack, Small Business Administration, Social Security and Aid for Families with Dependent Children--if the expenditure cuts are used to reduce the budget deficit. But two things must be immediately said about this:

1. Merely to list such programs is to show that consideration of growth effects is not conclusive. There are many other objectives involved.

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[1] Herbert Stein, "Reflections on Economic Growth", The AEI Economist, September, 1985, p. 10.

Promoting growth by such cuts involves a cost, and these costs have to be balancing against the gain in growth. There is no objective way to do this balancing, and opinions about the relative costs and benefits will certainly differ. I may think it worthwhile to cut agricultural programs but not Aid for Families with Dependent Children. Attitudes on this are probably different in Kansas.

2. We should try to be realistic about the size of the growth benefits that can be achieved by cutting government expenditures, or by raising taxes, for that matter. Great results should not be expected from small measures. The main effect of such measures is to increase savings available for private investment by reducing the budget deficit. A calculation by Edward Denison suggests that to raise the annual growth rate of real income per person employed in private non-residential business by 0.2 percentage points would require increasing investment in that sector by 1.75 percent of net national product, or 22 percent of the average postwar net savings rate.[2] This would require, for example, cutting the total of all Federal non-defense discretionary expenditures by one-third and getting the saving transferred to private investment.

These basic points about increasing growth by budgetary means--cutting expenditures or raising taxes--apply also to non-budgetary means aimed at raising the high-employment level of output by using the existing resources more efficiently. Typically such means involve removing impediments to the market allocation of resources. Reducing barriers to international trade, which protect and retain resources in industries where they are not most productive is the leading example. Denison has estimated that complete removal of barriers to trade might raise total output in the United States by about 2 percent; if achieved over ten years that would raise the annual growth rate by 2 tenths of one percent for that period. In the process numerous industries and their employees now enjoying protection would be injured. Removing other sources of misallocation of resources, such as those arising from inequities in the tax system, would probably have smaller growth-promoting effects. And we have a current example, in the case of tax reform, of the injuries that are claimed to result from that.

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[2] Denison, E.F., Trends in American Economic Growth, 1929-1982, The Brookings Institution, 1985, p. 59.

Measures to improve the allocation of resources can, in principle, go beyond such negative steps to the positive promotion of particular industries. Agriculture is probably the most successful case of that in American history. But it seems clear that the political process will generate more claims for this kind of promotional effort than can be justified by the probable gains in growth.

The net of the foregoing discussion is that government can do things to raise the high-employment level of output and its rate of growth--but these things will certainly not be costless and will almost certainly not be cheap. An enormous amount of resources and talent, mainly private, is now devoted to achieving the growth we experience. To increase that growth significantly will require a very large increase in the resources and talent devoted to growth. Decisions have to be made about how far that is worthwhile. These decisions cannot be given objective, quantified answers, but they raise the question of what the general stance of public policy should be.

Twenty years ago I would have said that affecting the rate of economic growth was not part of the government's business--unlike the creation of conditions for high employment. The national rate of economic growth is simply the sum of the results of decisions of tens of millions of individuals about the use of their own resources. The government should stay out of that. I would not say the same thing today. I would find it hard to define what "staying out of it" means. The government must make a number of decisions that affect the growth rate and some of these decisions, notably the size of the deficit or surplus, can not be sensibly made without consideration of their growth effects. Moreover, if the society through its government decides that it has a strong preference for a higher growth rate than "uninfluenced" private efforts would yield I can see no way to deny the legitimacy of an effort to achieve that as long as basic freedoms are not impaired.

But when that has been said the priority to be given to the goal of increasing growth remains a question. In my opinion that goal does not deserve high priority. I cannot look at the United States or at the world today and say that one of our major problems is that U.S. output is too low or grows too slowly. I would not basically change the conclusion that Edward Denison and I came to twenty-five years ago in a report for President Eisenhower's Commission on National Goals:

> ....any goal is proposed at the expense of others that are or might have been advanced, and the cost of elevating accelerated economic growth to the front rank of goals is that something else is deprived of that position. The number of goals calling for our attention is large--to help set the underdeveloped world on the path of economic progress, to reduce the barriers of nationalism and racialism, to strengthen our national security, to improve the lives we lead with our immense flow of goods and services, to set a floor of economic security and welfare for all. We need not feel guilty of negativism or passivity if we decide that accelerating growth is not one of our most critical needs.[3]

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[3] Commission on National Goals, Goals for Americans, (New York: Prentice-Hall, Inc., 1960), p. 190.

Mr. **Silk**. Thank you, Herb.

Our fourth and final speaker this morning is Michael Boskin, who is professor of economics at Stanford University. He is also research associate at the National Bureau of Economic Research, and he has formerly taught at the University of California at Berkeley and at Harvard.

PRESENTATION OF MICHAEL J. BOSKIN

Mr. **Boskin**. Thank you, Leonard.

Let me first say that while I agree with my friend, Herb Stein, that the United States is a very rich country and that as we get richer perhaps the need for future growth slows, those are the same arguments that were made when I was an undergraduate in the late 1960's, at a time we were growing rapidly, because we noted how much more rapidly Japan, Germany, and other countries were growing. We were much richer than they and the argument was when they got to be as well off as we their citizens would desire or their economies would produce less rapid rates of growth.

Well, indeed, that has not transpired. Other countries have become as wealthy as we and the Japanese are only a short step behind, and indeed, they are continuing to grow rapidly and to avoid polices that hinder growth.

That is not to say that governments are very good about knowing what generates economic growth, partly because economists' empirical information about the quantitative relationship linking things such as education expenditures, Government and private investment, and the like to economic growth are much less well defined than the qualitative directions of change that we attribute to such things.

I want to speak for a moment about the relationship between saving and economic growth and the two-way causality that may well be involved. It will sort of come full circle and get us back to the morning's discussion about our Government's borrowing because the U.S. national saving rate, net of depreciation, is abysmally low and has been for several years by historical and international standards.

In the last several years net national saving in the United States has been 2 to 4 percent of gross domestic product compared to twice that in Canada, 2½ times that in Germany, and 4 times that in Japan. While our saving rate rebounded a little bit in 1984, it's still much lower than in the 1950 to 1980 period or that of any other advanced major economy.

There are lots of measurement issues that we could go into, some of which were touched this morning in measuring Government borrowing or saving, but I won't bore you with them now unless they come up in questions and answers. But I will say that I think everyone will conclude that our net national saving rate has fallen substantially. Saving is important for two reasons, one of which was stressed by the panelists this morning and my colleagues on this panel, which is that domestic saving is a source of funds to finance our own domestic investment. If we don't finance it ourselves in the short run, we will have to borrow from abroad. And, indeed, we have, to everyone's surprise, as Herb indicated, in record amounts, offsetting about half or more of our Government's fiscal deficit.

We know that can't continue forever, at least at current interest rates. Evenutally foreigners will become more and more dubious of putting larger and larger fractions of their portfolios into dollar denominated assets and will demand higher returns to compensate them for greater risks. When that would have to slow down, whether that's in a year or 2 years or 10 years, no one knows. Suffice it to say that there is no compelling example in all of economic history of an economy which was advanced at the stage of history you're talking about which managed to finance its long-term growth over decades, not quarters or a year or two as we tend to think of in Washington, by financing its investments by importing capital. Usually the wealthy countries have been exporters of capital.

A second important reason savings is important is because it's the primary vehicle by which our citizens transfer resources over their lifetime: For example, from their peak earning years to the years of retirement. And we run the risk at very low rates of net national saving not only of being in this precarious long-term situation, although very beneficial short-term situation of having all this foreign capital flowing into the United States, but also of having future generations of elderly Americans showing up on the eve of their retirement depending still more on Social Security and other public transfers than current generations of retirees relative to their income.

I think it's very important to keep that in mind. We also have to keep in mind two issues related to saving and economic growth. Simple correlations of saving and growth rates tend to be made. We note that Japan has a high growth rate and a very high saving rate. We tend to think in the popular press that the saving rate causes the high growth rate.

First of all, a high growth rate is likely to feed back on a higher saving rate. This is because in a high growth economy the younger working and saving population will be more wealthy relative to the retired dissavers than in a more slowly growing economy. So part of the reason we see a simple correlation, albeit far from perfect, between saving and growth rates in this causality from high growth to high saving with some life-cycle saving going on in the economy. It's a source of some controversy in economics as to how much saving behavior in the United States or elsewhere can be explained in this way, but I think the professional consensus is that at least a substantial fraction can be.

Let me then go on to suggest that we have at least two other major problems in measuring saving and in dealing with saving, but saving does promote economic growth through the ability to finance investment and the potential feedback of that investment on higher rates of technical change in our growth rate.

In the short run, a higher saving rate can only really be accomplished in the United States by less Government borrowing. We have lots of ways we potentially could affect our private saving rate, but none of them could result rapidly in anywhere near the size of change in our national saving rate as a substantial gradual—say over a few years—reduction in Federal deficits.

Our tax policies and our Federal Government borrowing have left us with a saving policy or national saving which is substantially lower than that which an undistorted private market would generate. It also appears from my own current research that the current generations of workers and savers are saving less at the same age than their parents' generation did, which would exacerbate any problems that a fiscal deficit would cause because it would be offset against a smaller private saving pool.

Let me conclude, therefore, by suggesting we need to take a more comprehensive view of our Nation's wealth. We need not just to look at the Federal Government's borrowing. As indicated this morning, we need to look at the Federal Government's assets. We need a proper separation of capital and current expenditures in the budget and a more comprehensive budget, inflation accounting, and so forth.

We need to realize what's going on in the State and local sector. The State and local surplus is heavily in their pension programs which are accruing liabilities very rapidly. We need to realize what's going on in private accumulation of assets and liabilities.

We all believe that a broad-based lower rate tax system possibly raising some more revenue would be better than the current tax system. The bill that came out of the Ways and Means Committee is heavily antisaving and anti-investment in character and it seems to me it is as foolish to think of leaving our children and grandchildren less private assets as it is to leave them larger public liabilities.

Thank you.

[The complete presentation of Mr. Boskin follows:]

Saving and Economic Growth in the United States:
Policy Issues and Options

by

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Saving and Economic Growth in the United States: Policy Issues and Options: ABSTRACT

by

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The U.S. net national saving rate is abysmally low by historical and international standards. The potentially deleterious consequences of a low rate of U.S. saving range from increased reliance on foreign capital to finance our domestic investment, together with the concomitant appreciation of the dollar; potential crowding out of net exports, business tangible investment, and state and local government investment; and the baby-boom generation showing up on the eve of its retirement having saved a lower fraction of its lifetime resources than previous generations of Americans, still more dependent upon Social Security or other public transfers of funds financed by taxes on the then working population.

Rapid economic growth increases the saving rate as a larger share of society's resources are in the hands of the workers and savers as opposed to the retired dissavers. But it will be necessary for us to finance our own investment in the long-run from our own domestic saving. A higher saving rate may lead to a higher rate of investment which may feed back on a higher long-term sustainable growth rate. In the short-run, of course, a higher rate of net national saving is likely to decrease our current account deficit.

We conclude that by far the most potent policy vehicle for altering the rate of national saving is a change in rate of government saving or dissaving. While the structure of capital income taxes, the level of government consumption, and intragenerational redistribution might have some impact on the saving rate, they are unlikely to have nearly the impact of public debt policy.

Economic policy in the U.S. has created a situation where the U.S. net national saving rate is far below that which an undistorted private market would generate. Neutrality should be the primary goal of national saving policy. We should remove the obstacles and distortions to saving caused by current policies.

Looking toward the future, there will be some natural tendencies for saving rates to change. In the United States, the changing age structure of the population may result in a gradual increase in saving rates during the peak earning years of the baby-boomers. However, there is empirical evidence that this generation is saving less, at the same age, than their parent's generation. Government saving is more

difficult to forecast. A substantial long-term deficit looms in the hospital insurance part of Social Security, and probably also in OASDI unless we are able to accumulate an enormous surplus without dissipating it. Likewise, the state and local surplus is in part misleading, as it is largely in public pension funds, without the corresponding accounting for the simultaneously accruing liabilities.

There will be a natural tendency for the saving rate to fall in the country providing the greatest amount of capital to the world capital market, namely Japan. This is because of impending dramatic changes in Japanese demography. Japan is a younger society than the United States, with a more rapid rate of economic growth, but its population will age more rapidly over the next several decades. This is likely to result in a decline in the Japanese saving rate, and a rise in the fraction of any increased U.S. saving finding its way into increased domestic investment rather than a reduction in our current account deficit..

We conclude that the case for removing the policy obstacles and distortions to saving in the United States is strong. The best place to start is with reduced government dissaving or borrowing and with restoration of the principle of long-term inflation-adjusted balance in a comprehensive properly measured current operating budget for the federal government. The next most important policy would be to move the structure of our tax system toward neutrality, both between consumption and saving, and among types of saving, by transforming our current system of corporate and personal income taxation into a general personal consumption tax.

1. Introduction

The United States saving rate is abysmally low by historical and international standards. For example, in 1983 the net national saving rate[1] in the United States amounted to 2.2% of gross domestic product (GDP), compared to 7.3% in Canada, 9.2% in Germany, and 15.7% in Japan. While our saving rate has rebounded slightly since then, it is still much lower than in the 1950-1980 period, or any other advanced major economy today. Numerous measurement issues abound in analysing, measuring or interpreting aggregate saving or its components in the U.S. as well as in other countries. Table 1 presents a recent history of the major components and aggregates of saving and investment in the United States. As can be seen, the saving rate has plummetted in the 1980s as a result of the large federal budget deficit, and we are relying on imports of foreign capital to offset half of our federal government's borrowing.

Saving is important not only because it is the source of funds to finance our own domestic investment -- business tangible capital formation, government investment, and housing -- but also because it is the primary vehicle by which households may transfer resources over their lifetime, for example, from their peak earnings years to retirement (and to a lesser extent for bequests).

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[1] National saving is the sum of saving done by federal, state and local governments, households, and businesses. Net saving subtracts depreciation or capital consumption from gross saving, and therefore, represents the addition, after allowing for replacement of the depreciating capital stock, to our national wealth.

In addition to our low rate of saving, and our low, but not quite so depressed rate of investment, the efficiency with which we allocate our saving and investment is also important. In general, we would like the private market to allocate our saving to those uses with the highest expected return.[2]

It should also be clear that simple correlations of saving and growth rates can be misleading. Clearly, Japan has had the most rapid rate of growth among advanced economies and also the highest rate of saving. But which way does the causality run? There are well-documented reasons for believing a rapid growth rate will feedback to a higher saving rate, as well as the conjecture that a higher saving rate will lead to greater investment and perhaps also to greater technical change, which in turn may increase the growth rate.

Suffice it to say that our low rate of national saving, and to a lesser extent, its misallocation among alternative uses, is a vital national issue. The purpose of this paper is to analyse the relationship of saving and economic growth, discuss various problems in measuring and interpreting our national saving rate, evaluate the claims that various types of economic policy affect our national saving rate adversely, and propose a standard against which economic policy and its impact on saving may be measured.

Toward that end, the paper is organized as follows. In the next section we present a very brief overview of discussions of saving in the last four decades of reports of the Joint Economic Committee and the Economic Report of the President/Report of the Council of Economic Advisers. We note that until recently saving was hardly a primary concern of either the JEC or the CEA. This undoubtedly reflected in part the prevailing view that the major problem confronting the U.S. economy in the post-World War II period would continue to be insufficient aggregate demand -- a legacy of the experience in the Great Depression. Only in the late 1970s and early 1980s did our inadequate rate of national saving and its potential consequences, together with major policy proposals or initiatives to enhance our rate of saving come to the fore in the deliberations of the JEC and the reports of the CEA.

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[2] While the amount of saving and investment is probably more important than the efficiency with which we allocate it, based on many quantitative studies, the latter is still important.

Section 3 reviews the relationship of saving and economic growth and discusses various cause and effect relationships between them. It also discusses evidence for substantial lifecycle patterns of saving, although not in a no-bequest framework. This leads to a discussion of the relationship of saving to investment in the short and long-run in both closed and open economies; a discussion of the factors determining the underlying long-term growth rate of the economy as opposed to its short-term transition to a new growth path; potential avenues by which greater investment may feedback on greater technical change and hence, an enhanced growth rate in the long-term as well as the extent to which we may need to rely on our own domestic saving to generate such domestic investment. It provides historical examples of the confusion between an underlying change in the long-term growth rate and the transition to a new growth path caused, for example, by temporary changes in the rate of growth of the labor force.

Section 4 turns to issues in measuring national saving, both private and government. It discusses various shortcomings of the National Income and Product Accounts (NIPA) definitions, together with alternative estimates derived from the Federal Reserve's Flow of Funds, which in principle captures some items excluded by the National Income and Product Accounts, but may be subject to other types of measurement problems and are not independently reconciled to measures of investment. Problems in measuring government saving or dissaving, ranging from the fact that the United States federal government does not keep a separate capital account to the vast amount of implicit debt of federal, state and local governments through their Social Security and state and local government employee pension programs, respectively, are discussed. Other measurement issues such as inflation-adjustment of the previously outstanding debt are included, although to the extent that the holdings are internal as opposed to holdings of government debt by foreigners, this is a purely intersectoral transfer in terms of the capital gains and losses on previously issued government bonds from changes in inflation and/or interest rates.

Section 5 discusses economic policy and national saving. It lays out the structure of four types of policies that might conceivably affect national saving in the future, may have affected it in the past and may be responsible for some of the decline in the U.S. saving rate. We conclude that whether or not it is desirable on other grounds, decreases in the level of government consumption are unlikely to have a substantial impact on net national saving. Likewise, while probably undesirable on distributional grounds, intragenerational redistribution from poor to rich, given the likely maximum potential difference in the propensity to save by income is also unlikely to be capable of raising the saving rate nor is the growth of welfare payments likely to be a primary explanation for the decline in the national saving rate. A likely candidate for the changing saving rate and also as an explanation for some of the decline in our private saving rate in the United States has been the structure and level of our tax system, especially marginal tax rates on capital income. We conclude that this is likely to be a problem, both with respect to the level and composition of saving and investment, but it is unlikely to be as quantitatively important as economic policy affecting intergenerational redistribution or public debt policies. I conclude that public debt policies are the primary reason for the decline in the saving rate in the United States, not just recently, but also over a longer span of time, and that reductions in the rate of debt accumulation are the most potent vehicle for raising our net national saving rate. This section also evaluates some of the statistical evidence upon which various of these conjectures rest, such as the conjecture that public debt affects private saving.

Finally, the conclusion looks toward the future and discusses potential natural tendencies in saving, due to changes in demography, already predictable future liabilities of the federal, state and local governments related to retirement income support programs, changes in saving rates in other advanced economies due to demographic changes, and other factors likely to affect saving, such as changes in risk.

Thus, the policy goal of neutrality toward saving has been violated with respect to the level of saving that would be produced by an undistorted private market and also to its allocation among types of saving and investment. Removing these distortions and obstacles such as reducing the amount of federal government borrowing and moving toward a more neutral tax system are likely to lead to important improvements in our economic performance over the long-term. In the short-term, any increase in our national saving rate is likely to have its primary impact via a reduction in our current account deficit. Over the long-term, however, these improvements should allow us to finance a greater rate of tangible business investment, as well as possible state and local government capital expenditures and residential construction, generate increased assets for future generations of retirees so that they are not increasingly dependent upon Social Security for retirement income support and increase the efficiency of our capital markets.

2. Discussion and Analysis of U.S. Saving in Reports of the Joint Economic Committee and the Economic Report of the President/Report of the Council of Economic Advisers: A Cursory Historical Review

From 1949 to 1979, discussions of saving behavior in the Economic Report of the President/Report of the Council of Economic Advisers and the Joint Economic Committee Reports were framed almost entirely within the Keynesian aggregate demand framework. Trends in the percentage of disposable income being spent versus saved are reported and analysed. A few notable exceptions in this period are discussions of saving in terms of the distribution of income[3]; saving and inflation in the 1970s[4]; discussions of the sectoral flows of savings and their implications[5]; tax changes and their effects on saving[6]; and discussions of alternative measures of saving.[7] By the late 1970s, the discussion of saving behavior based solely on the Keynesian aggregate demand framework came under criticism from a variety of perspectives and a concern with the "supply-side" of the economy emerges in the Joint Economic Committee Reports. Beginning in 1979, saving became a big issue, particularly in 1980 and 1981. The discussion has turned from how to encourage consumption to what measures are needed to stimulate saving, e.g., tax policy to bolster capital formation. Many of the nation's most prominent economists in this period expressed a concern over our low rate of saving and capital formation and called for various policy changes to promote saving. This concern spans a wide range in the political-economic spectrum, ranging from Lester Thurow to Alan Greenspan and Martin Feldstein, with additional comments by what might be termed extreme supply-siders. The refreshing change away from the view that the federal government can, or at least should, attempt to fine-tune the economy via managing aggregate demand, irrespective of the ultimate long-term consequences including those for saving, gives way to renewed emphasis on longer-term considerations reflecting growth, capital formation and saving. It should be emphasized that while a consensus among a broad range of economists existed that our national rate of capital formation should be increased and that tax and fiscal policies were important potential instruments in achieving that goal,

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[3] See the Economic Report of the President 1950 and 1964 and Reports of the Joint Economic Committee 1971 and 1972.

[4] Economic Report of the President 1976 and 1974 and the Reports of the Joint Economic Committee, 1972 and 1976.

[5] Reports of the Joint Economic Committee 1959, 1964 and 1966.

[6] Economic Report of the President 1965 and Reports of the Joint Economic

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Committee 1963 and 1969.

[7] Economic Report of the President 1971 and Report of the Joint Economic Committee 1949.

the notion that broad across-the-board tax cuts were likely to lead to a substantial increase in saving never had very much serious empirical support. In fact, for a broad across-the-board tax cut to result in a net increase in saving, the tax cut would have to expand GNP many times any sensible estimate and then a large multiple of the typical propensity to save in the economy would have to be saved out of this increased income.

It is also worth noting that substantial discussion of debt accumulation, both private and public, occurs sporadically throughout the reports of the Joint Economic Committee and Council of Economic Advisers and the Economic Report of the President for 1982 raises a variety of conceptual and accounting issues with respect to public assets and liabilities which suggests that commonly used measures of deficits can be quite misleading.

3. Saving and Growth: Potential Interactions

Saving and growth may be related in a variety of ways. Contemporaneous correlations of high saving and growth rates, compared across countries, or an inverse correlation caused by economic fluctuations within an economy are interesting phenomena but inconclusive. The saving behavior of an economy does reveal much about the nature of its values, institutions, incentives, demography, and economic growth. It is a fundamental reflection of the relative value placed on the future by its citizens, and perhaps, political institutions. The first question we must ask in a discussion of saving and growth is simply how much should we save? It is clear that we could save too much. In order to increase saving, we must forego consumption.

Therefore, we must somehow balance the benefits of increased consumption in the future with the cost of foregone consumption today.

We begin with the assumption that long-run capital formation in the United States must ultimately be financed by domestic saving rather than imported capital. While the supply of foreign capital to the United States is quite elastic in the short-run, it is unlikely that we could finance our investment over decades by substantial imports of foreign capital. Eventually, foreigners would find increased investment in dollar-denominated assets in the United States to be increasingly risky, and are likely to slow the rate at which they are willing to supply capital to the United States at given interest rates.[8] With perfect capital markets and the absence of taxes, consumers will save to the point where their subjective time discount rate equals the rate of interest, which in turn would equal the marginal product of capital. However, capital income taxes will reduce the net return to savers well below the marginal product of capital, and government borrowing in the long-run (if investment is constrained by the supply of domestic saving) will drive up interest rates, crowd out investment (of all types), and decrease the rate of capital formation (assuming all of the government borrowing is not used for government investment which is at least as productive as the crowded out private investment). Thus, unless somehow offset elsewhere, capital income taxes and the government deficit may distort the first best optimal saving and capital formation in the economy.

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[8] Clearly, imports of foreign capital raise a variety of important issues with respect to how much we should be saving. First, in the short-run, it is likely that the elastic supply of foreign capital means that increased domestic saving will have its primary short-term impact on the current account deficit and exchange rates and international competitiveness. Second, investment which is financed by foreign capital is better than none at all, since it increases the future productivity of American workers. However, the income from the capital eventually accrues to foreigners, rather than Americans. Therefore, foreign capital flows into the U.S., while beneficial in the short-run, do nothing to increase the retirement nest egg of future cohorts of retirees in the United States.

Turning to dynamic efficiency or so-called "golden rules of economic growth", in simple growth model terms, each saving rate (in a closed economy where saving is directly translated into investment) leads to a particular steady growth path, so that the most desirable growth path implies a most desired saving propensity. If we take our social objective as maximizing per capita consumption, we can ask what characteristics or growth path maximizes consumption. It turns out that along such a growth path, the marginal product of capital should equal the growth rate, approximately the sum of the rates of population growth and technical change. Averaged over long periods of time, the real growth rate in the U.S. economy ranges from 3% to 3.5%, whereas the marginal product of private capital appears to be substantially larger. Thus, we are undersaving, and an expansion of the capital stock is in order until the marginal product of capital is driven down to the growth rate.[9]

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[9] This analysis can be criticized because it occurs in a simple one sector certainty context. For example, in a capital asset pricing context, suppose the risky asset is the market portfolio and there is another safe asset, say Treasury bonds. The real return to the safe asset may be below the growth rate, but the expected real return on the market portfolio may substantially exceed the growth rate. Are we under or over saving and investing? This question has not been adquately answered theoretically, but intuitively, it seems that the answer almost certainly is that we ought to be equating the expected return on the market portfolio to the growth rate.

Thus far we have adopted the usual and convenient assumption of a constant exogenous rate of technological progress which underpins the basic increase in productivity in the economy. However, in the process of investment and production, new techniques or new products may well be developed, i.e., so-called learning-by-doing generates an external benefit, raising the growth rate with greater investment, making our desired saving rate still higher. Further, if advances in technology are embodied disproportionately in new capital, higher saving and investment may raise the rate of technical progress or at least temporarily diffuse the new technology more rapidly.[10]

Thus, there are avenues by which increases in saving can increase the long-run growth rate or least help us to move to a higher growth path on which the level of income is higher than that associated with a lower saving rate, but with the same eventual long-term growth rate. Recall the proviso above that we are assuming domestic investment ultimately is constrained by the supply of domestic saving. There is no compelling example in economic history of an advanced economy financing its long-term economic growth by importing capital continuously.

There are a variety of other short-term potential relationship between saving and growth rates. In a classical short-run Keynesian deficient aggregate demand framework, an increase in the propensity to save might temporarily reduce GNP and via the so-called paradox of thrift, even might actually reduce ultimate saving temporarily. It is now the consensus among economists that such an analysis is at best confined to the short-run and at worst, dramatically overstated for a variety of reasons, probably the most important of which is how open the economy is in the short-run to both trade and capital flows. This implies, for example, that an increase in domestic saving rather than causing a sharp reduction in GNP is likely to be followed by a slight decline in interest rates, a depreciation of the currency, and a stimulation of investment and net exports offsetting most of the decreased first-round of spending.

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[10] For the development of learning-by-doing, see Arrow (1962); in the Cobb-Douglas case, Phelps (1968) demonstrates that the long-run age structure of the capital stock is independent of the saving rate, but higher saving rates will still translate to a higher growth path more rapidly, and these output gains may be large for a long-time. With more general technology, the embodiment of new technology can lead to a higher growth rate.

There is an important link between saving and growth that works in exactly the opposite direction: from the growth rate to the saving rate. While a matter of some controversy, it appears that a substantial fraction of saving in advanced economies can be explained by lifecycle factors such as the desire to smooth consumption by saving in peak earning years and dissaving during retirement. Thus, at any given point in time, the aggregate saving rate in the economy is an aggregation of different saving rates for people of different ages (and perhaps also other characteristics such as income or time preference) and dissavers. In a simple model, consider the savers to be workers in their peak earning years and the dissavers to be retirees. Thus, the aggregate saving rate will reflect, amongst other things, the distribution of resources between the savers and the dissavers. If the ratio of workers to retirees is large, and the rate of economic growth very rapid so that the workers over their lifetimes are much wealthier than the retirees were over their lifetimes, a high saving rate will result and conversely. This is one, and I stress only one, of the major differences between the United States and Japan. The Japanese have a younger population and an economy which has grown much more rapidly, and thus the ratio of income earned by workers in the saving part of their lifecycle to income received by retirees in the dissaving part of their lifecycle is higher in Japan than in the United States. It also suggests that when changes in demography occur, we should expect changes in our measured aggregate saving statistics to occur also. For example, it is predicted that Japanese society will age even more rapidly than the United States, and according to this view, ceteris paribus, this will decrease their saving rate. A related phenomenon occurs when there are temporary increases in the rate of growth of the labor force. A good example occurred in the United States with the movement of the baby-boom generation into the labor force as well as the substantial increase in the labor force participation of second-earners in the family. This led in the 1970s to a bulge in the labor force which has several potential impacts on saving. First, GNP in the aggregate expanded much more rapidly than productivity. The ratio of workers to the population increased dramatically. In fact, in the 1970s, GNP per worker hardly increased at all, whereas GNP per capita increased substantially and aggregate GNP increased at about its normal real rate. This increased output led to increased investment and a possible temporary increase in the growth rate and to a temporary shot in the arm to the saving rate in the 1970s, although the age structure of the growing labor force worked in the opposite direction as it was disproportionately younger persons establishing households, who also have a low propensity to save.

Simultaneously, fertility rates plummetted and life expectancies of the elderly rose substantially. These could have dramatic impacts themselves on saving. The decrease in fertility, while perhaps also a reflection of underlying time preference, suggests that the need to save in order to finance the upbringing of more children has decreased, whereas the increase in life expectancy conditional on reaching age 65, for example, would be expected eventually to lead to increased saving as today's younger workers plan for a longer retirement. Both however may be reflected in various types of decreases in risk, including mortality prior to old-age, and income fluctuations or loss. The longer life expectancy combined with the substantial growth of real Social Security benefit payments around 1970, both transferred resources to the elderly and created a situation where they are going to need them over a longer period of time. This may have affected the dissaving patterns of the elderly, as has the recent episode of high real interest rates. Since the elderly disproportionately are the holders of interest bearing assets, high interest rates temporarily may result in more dissaving by the elderly since they can spend more, given the high return on their accumulated wealth, and still have any given amount for future contingencies.

Thus, the relationships between saving and growth are complex. It is likely that over long spans of time, by which I mean decades as opposed to quarters, a higher saving rate in the United States will lead to at least a temporary rise in the rate of growth and higher standards of living and perhaps also to a permanent increase in the growth rate.

4. Difficulties in Measuring National Saving

Saving, foregoing consumption and providing funds either directly or indirectly to capital markets to channel into tangible, financial or human capital, is a neat concept, but there are an inordinate number of difficulties in measuring it. We begin with a discussion of recent post-war saving behavior by focusing on the most commonly used measure, total net national saving as a fraction of Gross National Product, as measured in the National Income and Product Accounts (NIPA). These results are presented as decade averages for 1951-80, and annually since then in Table 1. Total net national saving is the sum of net private saving, the state and local government surplus (or deficit), and the federal government surplus (or deficit). Private saving, in turn, is the sum of personal saving and corporate saving. Further, gross private saving is the sum of net private saving and the capital consumption allowance. These data are also presented as memoranda in the Table.

Even a cursory examination of the Table suggests that the total net saving rate has fallen substantially from the 1950-60s. While net private saving rebounded somewhat in 1984, approaching its historic norm, net government dissaving (the federal government deficit minus the state and local surplus) more than offset this rebound in private saving.

Numerous conjectures have been made concerning whether the appropriate rate to study is net or gross, private or total, or disaggregated private saving (personal and corporate). For example, David and Scadding (1974) find that the gross private saving rate at full employment is remarkably constant, reinforcing the finding of Denison (1958). They infer from this that households see through the "corporate veil" and movements between personal and corporate saving reflect various factors such as changes in the relative tax advantages of the two forms of saving. However. they strongly reject the "ultra rationality" argument that households see through the "government veil", an argument associated with Martin Baily (1962) and Robert Barro (1974). However, focusing on gross saving and its apparent stability seem odd, since virutally all of our theories are in terms of how households, firms and even governments wish to form their net wealth position. In brief, any rationality hypothesis seems somewhat out of balance if it ignores the fact that depreciation is estimable. There has been much less stability in the net private saving rate, or in the net national saving rate, than in the corresponding gross figures, (e.g., if one examines the annual, rather than the decade average, data).

Before turning to a discussion of other potential data sources and concepts, it is worth noting some potential problems with traditional figures. First, household saving in the National Income Accounts is estimated as a residual, after subtracting consumer expenditures, taxes, and interest payments to business from estimated personal income. The measurement errors in these components, each of which is potentially large relative to net saving, will show up dollar for dollar in the numerator of the net saving rate. This could lead to non-trivial mismeasurement. Second, the National Income and Product Accounts' measure of saving excludes net capital gains or losses in its measures of saving, as in its measures of income. Third, the National Income and Product Accounts treat expenditures on consumer durable goods as consumption, rather than saving (although the recent classification of home computers as investment may be the first step toward an improved classification system). It would be preferable to treat expenditures on consumer durables as saving, and the imputed rental flow of the durables as consumption. Fourth, the treatment of government saving or dissaving in the National Income and Product Accounts is a mechanical reporting of the budgetary position, with no attempt to develop a separate capital account on the expenditure side for government units in reporting a surplus or deficit on current operating account. Of course, the federal government's own budget suffers from this difficulty, but the Department of Commerce does attempt to estimate the government capital stock, investment, and depreciation (although these estimates are not devoid of their own problems). They just are not implemented in the reported figures for the government surplus or deficit. Given the vagaries of classification, reporting, etc., perhaps this is sensible. Still, during periods of rapid increases or decreases in the rate of federal, or state and local, investment-type expenditures relative to the depreciation of the existing government stock, these numbers can be quite misleading (see Boskin (1982, 1986), Eisner and Pieper (1984)). Worse yet, no adjustment is made for (unfunded) accruing pension and Social Security liabilities, which could swamp the asset accumulation side of the balance sheet.

Table 2 reports several alternative methods of estimating net national saving incorporating some of these adjustments. The first column merely reproduces the data from Table 1, the National Income and Product Accounts (NIPA) net saving rates. The second column, however, provides data from the Federal Reserve's Flow of Funds balance sheets for the U.S. economy. In principle, they reflect current cost estimates for the assets and liabilities of each sector of the economy (households, businesses, and government). An inflation adjustment allows us to define saving as the difference in the real net worth from the end of one year to the end of the succeeding year, much closer to the economist's definition of saving. Unfortunately, bonds are valued at par, and therefore, capital gains and losses due to inflation will not be reported to the extent that there are net external bond holdings. However, this should not be terribly important since the overwhelming bulk of corporate and government bonds are held internally, and the capital gains and losses just cancel among sectors.

The Flow of Funds figures generally estimate higher net saving rates, probably primarily reflecting real net capital gains, and also wealth accumulated from the underground economy, then the NIPA net saving figures. For 1981, however, the Flow of Funds estimate reveal smaller net saving than do the National Income and Product Accounts and actually show a substantial decline in real net worth in 1982, negative saving, and a rebound to a net saving rate of about twice the NIPA level in the early stages of the recovery in 1983.[11]

Thus, a comprehensive measure of net national saving would adjust the National Income and Product Account definition to include purchases of consumer durables and government tangible capital as saving, subtracting out these purchases from consumption, while adding to the NIPA consumption figures the imputed rental flow of services from consumer durables and government capital. More formally,

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[11] It should be noted that these data are based on the November 1984 revisions of the national balance sheets provided by the Federal Reserve Board of Governors, and the previously noted negative saving for 1980 and 1981 (e.g., by Auerbach (1983), and Shoven (1983)) were based on earlier versions of the data. Another difference between these estimates and those presented in Auerbach or Shoven is that we use the GNP deflator, which is almost identical to the personal consumption expenditure deflator, whereas they use the Consumer Price Index. The widely documented overstatement of inflation by the CPI, in part because of its peculiar treatment of housing in this period, suggests that this was partly responsible for their estimates of negative saving rates.

$$NNSR = \frac{NNP^* - C^* - G^*}{NNP^*}$$

where NNSR is the net national saving rate and equals adjusted NNP minus private consumption minus government consumption divided by adjusted NNP. Adjusted NNP is NIPA NNP plus the rental flow from consumer durables and from government tangible capital, each net of depreciation. C* is NIPA consumption plus the rental flow from consumer durables net of depreciation less expenditures on consumer durables; G* is NIPA government expenditures plus the rental flow from government capital net of depreciation, less government investment expenditures. Since the rental flow is imputed for both durables and government capital as the product of a net capital stock and a real opportunity cost plus depreciation, errors in measurement of the real opportunity cost, or depreciation, will carry over dollar for dollar into errors in the measurement of private and government consumption and net national product. Therefore, improved measures of the stock of consumer durables, the stock of government tangible capital, and the depreciation and the real opportunity cost of using each are urgent research priorities. We present below several alternative estimates of these numbers, which vary substantially.

Table 2, column 3, reports net saving, adjusting the NIPA data for a consistent treatment of durables. We add durables expenditures, both government and private, net of depreciation to saving and treat the imputed rent from the stock of consumer and government durables as consumption. These adjusted net national saving figures are roughly double the traditional national income account figures. The denominator in the third column is net national product, not gross national product, and is adjusted for the imputed rent to government capital and household durables, less depreciation thereof. These adjustments are conceptually simple, but subject to potential large measurement error in practice. Since errors in consumption carry over dollar for dollar to errors in saving, this should be borne in mind. The data from which Tables 2 and 3 are based are from Boskin and Kotlikoff (1985).

Finally, Table 2, column 4, reports the same net national saving figure out of private net national product, as adjusted for the treatment of durables. Private net national product is defined to be adjusted net national product less government consumption.

Again, columns 2, 3 and 4 suggest a substantial decline in the net national saving rate in the 1980s, relative to the previous three decades. While we shall discuss in more detail below some conjectures concerning the reasons for this decline, particularly as they relate to government economic policy, it is worth noting that the most interesting and important demographic features of the economy: declining fertility rates, dramatic increases in life expectancy of the elderly, the accelerating trend to earlier retirement, all seem more likely to lead to an increase in saving rather than to its decrease, *ceteris paribus*.

An alternative interesting perspective is presented in Table 3, where we present different measures of consumption as a percent of net national product. First, we examine the ratio of private and government consumption including adjustment for durables as saving, and the sum of the two as fractions of adjusted NNP (the adjustments are for the imputed rent to government capital and consumer durable stocks less depreciation thereof), and finally, the ratio of private consumption to adjusted net national product minus government consumption, a measure of "disposable" income net of government expenditures. The data reveal that the private consumption rate has increased substantially, as has the total consumption rate out of adjusted NNP relative to the 1950s, 1960s and 1970s.

It is important to reiterate the potential importance of a conceptually proper separation of capital and current account for government units in the United States, including revaluation of their assets. As discussed in Boskin (1982, 1986) and Eisner and Pieper (1984), government assets are substantial and have been growing. These include substantial financial assets, as well as tangible capital such as buildings, inventories, equipment, and, as discussed in Boskin, Robinson, O'Reilly and Kumar (1985), a substantial value of land and mineral rights. Indeed, until the big increase in the national debt associated with the recent deficits, the value of oil and natural gas rights for the federal government alone exceed the value of privately held national debt. There are a number of intrinsic difficulties in trying to get replacement or market valuations for government assets. The overwhelming bulk of such values can be estimated, as the methodologies in the papers described suggest. Just saying that it is difficult to value the Grand Canyon misses the point that the bulk of government assets do have a value which can be reasonably estimated. However, many such assets are much more difficult to value than private assets, depreciate and obsolesce in a different manner, and in a way that is difficult to estimate from market data (e.g., military equipment), and may be subject to systematic changes in prices relative to the prices of private investment goods and commodities in general. As noted above, plausible differences in depreciation of government capital can cause large differences in measures of net national saving.[12]

Thus a major priority area of important research is improved government capital budgeting and budgets. This is important not only to improve data on net government capital formation and therefore, net national saving and wealth, but probably would be an important input to improved budgetary outcomes as well. A few cautious attempts in this direction have been recommended recently, but we still remain one of the major advanced economies in the world without a separate capital account. It is clear that a separate capital account for the government is not only harder, but more likely to be politically manipulated, than capital accounts for the private sector. But even a cursory examination of the data suggest that the numbers are very important. With respect to the data described above, we note that the big increase in tangible investment by the federal government occurred in the 1960s with the buildup of the interstate highway system and public infrastructure. Subsequent declines in military spending on investment-type goods reduced the rate of investment substantially until recently, when the increased rate of government investment in military equipment has more than offset the decrease in other types of federal government investment outlays.[13] Further, some of the investment expenditures of the government were driven by demographics, e.g., the buildup in expenditures on school buildings following the baby-boom.

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[12] See M. Boskin, M. Robinson, and J. Roberts, "New Estimates of Federal Tangible Capital and Net Investment," in D. Jorgenson, ed., Technology and Capital formation, Ballinger, 1986 forthcoming.

[13] See Op. cit.

Once again, the issue of the extent of substitution among different types of saving is important. By no means has the issue been exhausted analytically or empirically. Better theoretical and empirical understanding of the interrelationship among capital formation, i.e., net saving, of households, businesses, and governments, both federal, state and local, are another high priority item. Indeed, the data reported in Table 3 reflect this important distinction. Private consumption is reported both with respect to NNP and NNP minus government consumption. If government consumption is a perfect substitute for private consumption, the private sector's ultimate disposable income is simply NNP, and the private saving rate coincides with the net national saving rate. On the other hand, if government consumption does not enter private decision-making at all, or separably, in choosing its consumption level, the private sector would view NNP minus government consumption as its ultimate disposable income, since current government consumption must be ultimately financed by the private sector. Thus, in choosing the measure we wish to use to analyse saving, we implicity assume a theory of the relationship of government and private saving.

Finally, while we have noted some difficulties with the national income and product accounts measurement of saving, and therefore, presented alternative estimates, we should note one primary advantage of the national income and product accounts measures relative to Flow of Funds figures: they are reconciled with independently obtained estimates of investment, usually with only a minute statistical discrepancy.

Regardless of which set of figures one uses, net national saving in the United States plummeted from already low levels in the 1980s.

5. Economic Policy and National Saving

The two leading theories of private saving behavior are the pure life cycle theory of Modigliani/Brumberg/Ando (1954 and 1963) and the intergenerational altruism model of Barro (1974). In the Barro model, the government cannot affect national saving, since the private sector will offset any change in government saving or borrowing. The *pure* life-cycle model provides no automatic mechanism for individual households to account for the fact that future generations will be richer except by issuing greater public debt. There is no bequest motive and the average propensity to consume over the lifetime is one. Various studies have attempted to demonstrate that life cycle behavior can explain several important phenomena concerning aggregate wealth accumulation in the United States (see Tobin (1967)). More recently, there has been an attack on the pure life cycle model (no bequest, average propensity to consume over the lifetime of one) by a variety of authors. For example, Kotlikoff and Summers (1981) conclude that life cycle saving can account for only a fraction of the aggregate wealth in the United States.[14]

There have also been a number of studies attempting to examine the extent of dissaving after retirement. For example, Michael Darby (1978) demonstrated, using household data, that there was surprisingly little dissaving post-retirement, and concluded these results were incompatible with the pure life cycle hypothesis. Mirer (1979), David and Menchik (1980), and King and Dicks-Mireaux (1982) also find no dissaving after retirement and thus seem to be inconsistent with the pure life cycle model.

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[14] Unfortunately, a mathematical error in their derivation of the formulae is part of the explanation for their result. Further, the extreme concentration of financial wealth suggests that the distribution of returns to investment includes some extroadinarily high ex post returns. Using returns on government securities fails to capture this effect. Still, their results do give one reason to be chary of the pure life-cycle model.

In recent work, Bernheim (1984) and Diamond and Hausman (1984), using panel data, do observe dissaving after retirement. Bernheim (1984) also has established that in the presence of explicit or implicit (for example, by Kotlikoff-Spivak (1980) type of family insurance) annuities, estimates of dissaving should be adjusted by including the simple discounted value of pension benefits (e.g., Social Security benefits) in total wealth, rather than the actuarial discounted value. He further concludes that the response to saving and dissaving rates to apparently involuntary annuitization is inconsistent with the pure life cycle model.

Rejection of the pure form of the life cycle model should not be taken to mean that there is no consumption smoothing over the life cycle, or that the propensity to consume is independent of age. It is the rejection of the assumption that the average propensity to consume over the lifetime is one, and that there is no bequest motive (even accounting for the fact that an uncertain date of death may require very slow dissaving in the absence of actuarially fair annuities).

In an important study just completed, my NBER colleague Michael Hurd (1986) makes several improvements in the data, methodology and interpretation of such studies: a longitudinal data base spanning ten years rather than a cross-section or shorter longitudinal period, comparing couples with and without living children (potential heirs), more careful measurement, etc. His conclusion is in stark contrast to the studies cited above. He estimates substantial dissaving after retirement and a wealth-age relationship consistent with the pure life-cycle model. His tests for a bequest motive show no evidence of one.

A variety of studies presume the pure form of the life cycle theory in analyses of public policy. We shall comment on several below, but it is important to point out that one of the major conclusions from the pure life cycle model is that public debt -- explicit or implicit -- crowds out private saving, and by our assumptions, thereby capital formation. In an alternative model proposed by Barro, extending work of Baily (1961), and dating all the way back to Ricardo, a Say's law of public finance is developed in which increases in the supply of public debt call forth an increased demand for it. The argument is simply that in a world where there are intergenerational altruism and operative bequest motives -- as well as many other assumptions such as lump sum finance, etc. -- the private sector can undo the government's attempt to redistribute resources across generations.

Many studies have tried to analyse the effect of some measure of deficits or public debt on consumption (e.g., Feldstein (1982) and the numerous studies cited therein, and Barth, et.al., (1984) and the studies cited therein) or of unfunded liabilities in Social Security on the consumption/saving choice (see Feldstein (1974), Barro (1978), Feldstein and Pellechio (1979) among many). The conclusions are somewhat mixed. I believe that an accurate summary of the econometric literature is that Feldstein's original dollar for dollar estimate of the substitution of unfunded Social Security liabilities or public debt for private saving has been revised to 25 to 50 cents on the dollar.

Since concepts such as deficits, public debt and unfunded Social Security liabilities are subject to vagaries of accounting procedures, more direct tests of the intergenerational altruism model are possible. To see this, note that in the intergenerational altruism model aggregate consumption depends only on aggregate resources, not on their age distribution. This forms the basis for the test developed by Boskin and Kotlikoff (1985). We develop a finite approximation to the intergenerational optimization problem for Barro-type behavior under earnings and rate of return uncertainty, and demographic change, for the U.S. economy, and test whether, given the level of consumption predicted by this model, variables measuring the age distribution of resources influence actual consumption. Data on the age distribution of resources is obtained from the annual Current Population Surveys. The results, presented in a variety of forms using various measures of the age distribution of resources, reject the hypothesis that aggregate consumption is independent of the age distribution of resources. They therefore cast considerable doubt on the pure intergenerational altruism model and on the contention that government debt policy -- explicit or implicit -- does not affect the consumption/saving choice.

Thus, neither the pure life cycle model nor the pure intergenerational altruism model seems sufficient by iteself to explain aggregate saving behavior or the effects of policy on saving. Undoubtedly, different people in the economy could be described in their saving behavior by different models (including a Keynesian liquidity constraint consumption/saving model) and the convex combination that results in aggregate saving is some complicated combination of these models.

I do believe that it is important to realize, however, that there are substantial differences in the propensity to consume by age, some lifetime smoothing, and substantial bequests in aggregate capital formation. Thus, elements of both the bequest model and the original pure life cycle model are important in explaining saving behavior, despite the fact that each of the models in its most pure form is usually rejected in the data.

Another important controversy has arisen over the extent to which changes in the real after-tax rate of return affect private saving. As noted in Section 2, "Denison's Law" -- the apparent constancy of the gross private saving rate at times of full employment through the mid-1970s -- was often taken to suggest that tax policy did not affect aggregate private saving, but only its composition between the household and corporate sectors. Since there has been substantial controversy about structural tax policy and its effects on effective tax rates on capital income, renewed interest has focused on this issue. The article by Boskin (1978) sparked a substantial amount of controversy. In that work, I consistently found estimates of the real net rate of return elasticity of private saving of about 0.4.

While hardly enormous, such a modest interest elasticity has important implications for public policy. For example, the intertemporal efficiency losses in our tax system are large and swamp the atemporal inefficiencies due to misallocation of the capital stock among assets and industries, (see Fullerton et. al. (1983) who use my estimates). There are substantial difficulties in defining, estimating, and interpreting an interest elasticity of saving.[15]

While I do not think the issue is at all settled, I would ~~like~~ to share with you the preliminary results of a major study of post-war U.S. consumption that I have just completed with my colleague, Lawrence Lau.

The major innovation in our study is the use of annual Current Population Survey information on cross-tabulations of household characteristics, especially age of head of household, with income, and the building of age cohort-specific wealth accounts with which to analyse the share of wealth consumed in goods and as leisure. We build the simplest possible model that is a legitimate candidate for exact aggregation from individual behavior. The individual household's current period consumption and leisure are functions of the spot prices

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15. First, one must be careful in defining the conceptual experiment to decide whether one is holding a stream of income constant or wealth constant when one changes the real after-tax rate of return, e.g., by tax policy. Are we causing a change in the future after-tax stream of capital income which is exactly matched by a reduction in the rate at which it is discounted, thereby leaving financial wealth unchanged, but perhaps affecting the valuation of future expected earnings, and through this change in human wealth affecting consumption and saving? While numerous studies of the interest elasticity of saving abound, greater clarity on the exact questions being posed and the conceptual experiment being analysed is highly desirable. I confess to having been all too brief in my 1978 paper on this issue. Recent work has tended on the one hand either to confirm my earlier results or suggest that the rate of return elasticities are still larger (see Summers (1981, 1984)) or on the other hand to cast doubt on these results (see, e.g., Friend and Hasbrouk (1982), or Howrey and Hymans (1980)). A stylized finance model with labor earnings in period 1 and consumption out of interest income and assets in future periods yields the result that as risk aversion rises, the response of saving to the rate of return eventually becomes negative. While adding uncertainty to the model is a step forward, we should be careful in reading too much into this result. First, with many periods, including subsequent periods of earnings, the result is unclear; second, as noted above, in aggregating households to determine the response of total saving to rates of return, surely much of saving is done for longer term reasons, and examining behavior toward risk in portfolio allocation among the wealthy may be misleading.

of current period consumption and leisure and forward prices of future period consumption and leisure, wealth of the individual households, and the household's attributes. Under assumptions about stationarity of expectations, we define the forward prices at each point in time, and since time series data on individual households are not available, we use aggregate data on current consumption and leisure expenditures which satisfy necessary conditions for exact aggregation. They are consistent with "no money illusion" and thereby impose various restrictions on the parameters. The estimated equations for the U.S. post-war period perform remarkably well, predicting the share of wealth consumed with but small deviations. We then decompose the growth in consumption in the post-war period into its components. The approximate 3 percent average annual percentage change in consumption is decomposed into the total change due to changes in wealth, wage rates, rates of return, population growth, the age composition of households, wealth by age of the household, changes in female labor force participation, and the vintage of the household defined as whether or not the household head was born post or prior to 1939 and thus experienced the Great Depression first hand.

Several intriguing results emerge from that study. For the purpose at hand, suffice it to say that the estimated interest elasticities of saving are still substantial. Finally, we note not only that the propensity to consume varies with age, but that there is an intriguing difference both in the elasticity of consumption with respect to wealth, and in the shares of wealth consumed, as well as the interest elasticity of saving in the vintages of households born pre-1939 and post-1939. We find that at the same age, households born post-1939 have a higher propensity to consume out of their wealth than households born prior to 1939, but on the other hand, they are somewhat more responsive to changes in rates of return.[16]

These recent empirical results can be combined with the analysis presented above to generate several implictions for the analysis of fiscal policy, such as structural changes in tax policy, unfunded Social Security obligations, and the public debt. They suggest that a good working hypothesis is that unfunded Social security obligations and public debt do crowd out some private saving, but this is likely to be substantially less than dollar for dollar. The age distribution of resources does matter for aggregate consumption in the economy and changes in the age distribution brought about by age-specific fiscal policy -- such as increases in public debt or changes in the age structure of Social Security benefits and taxes -- are likely to change saving behavior.

The size of these variables -- a true measure of real public debt plus unfunded Social Security obligations (including those projected in Medicare) -- is quite large (Boskin (1986)). The unfunded liabilities in OASDI in present value terms were as large as the privately held national debt prior to the 1983 Social Security Amendments. Various tax increases, the projected building of a very large surplus in the period

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[16] I do not mean to suggest that the real net rate of return elasticity of saving is a closed theoretical or empirical issue, but my own judgement -- as devoid of personal bias as possible for someone who has spent much time working on the problem -- is that despite the numerous difficulties in such estimation, my work, and the work of Summers, even adjusted for the criticisms noted above, still lead me to believe that there is at least a modest positive interest elasticity of private saving in the United States.

1990-2015 (i.e., approximately one-third to one-half of GNP!) and gradual increases in the age of eligibility for retirement benefits reduce this estimated present value of the unfunded liabilities in OASDI approximately to zero.[17] Thus, even a partial offset of Social Security's unfunded liabilities, and/or the growing public debt, on private saving is likely to be the most compelling problem for those concerned about raising the saving rate.

It is my belief that while we still have substantial structural tax problems which inefficiently allocate the existing capital stock, and on balance curtail saving and investment, that these effects have been mitigated substantially. The growth of employer provided pension benefits, IRA and Keogh accounts, and the recent reduction in effective marginal tax rates on new investment in the corporate tax, are part of the reason.[18] Thus, we have been moving in a very haphazard way toward a consumption tax, as opposed to an income tax system. Much more could be done in this regard, but I do not believe that the structural nature of the tax system is sufficient to be the culprit by itself in the decline of our saving rate. I believe that the efficiency losses

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17. However, it would be naive to assume that the exempt amount in the income taxation of Social Security benefits will remain unindexed once the middle class has half of its benefits become taxable, and/or that we will passively accrue a surplus many times that of what Social Security has been able to accrue in the past. It is more likely that the surplus will be dissipated to pay part of the even larger deficit that is projected in the Hospital Insurance part of Medicare.

18. There is also a controversy over whether effective marginal tax rates on capital income really rose as much in the 1970s as has been suggested by some (e.g., by Feldstein and Summers (1979), but see the contrary view of King and Fullerton (1983)).

are large and that a substantial fraction of saving is done at the after-tax, not the before-tax, rate of return (e.g., approximately half of IRAs are at the limit allowed). Thus, the study of the interest elasticity of saving remains relevant for these efficiency issues, but I do not believe that the increases in capital income tax rates in the 1970s plausibly can be estimated to have been large enough in combination with reasonable interest elasticities of saving to suggest that they are the primary reason for the post-war decline in net saving. Nor can such structural tax policy changes be expected to be sufficient by themselves to cause a major increase in our national saving rate. They probably contributed something, and may well combine with our intergenerational transfer policies to have reduced our net national saving rate.

Recent proposals to reduce tax rates and broaden the tax base have sometimes carried with them the notion that they would stimulate saving and investment. Of paramount importance is how the base is broadened. If depreciation allowances are slowed down, tax free savings vehicles limited, etc., it is likely that the inclusion of more investment income in the tax base will more than offset any lowering of the rates. Only broad based consumption or consumed income type taxes among the reform proposals are likely to have a positive impact on U.S. saving. The reforms moving us closer to pure income taxation will likely do the reverse as they extend the double taxation of saving substantially (albeit at somewhat lower rates). Treasury I and the House Ways and Means bill are two important examples of reforms which would most likely retard aggregate capital formation.

I might add that analyses of recent saving behavior have tended to suggest causually that the 'supply-side' tax incentives did not work. While the investment boomlet we experienced in 1984 may well be in part a reaction to the tax incentives in ERTA/TEFRA, private saving has only rebounded slightly, and net private saving is still quite low. While there has been a substantial flow into IRAs, much of this comes from already existing assets, and only part is from accumulation of new wealth. Thus, some people see the sharp increase in real interest rates and the apparent modest response of savings as suggesting that there is not a very large interest elasticity of saving. I would rather suggest that an important institutional factor has been overlooked in these data. As pointed out by Shoven and Bernheim (1985), there is virtually an automatic negative interest elasticity in the personal saving rate because defined benefit pension plans will reduce their contributions substantially with increases in the interest rates assumed by actuaries which reflect historic experience in the economy. Thus, there was a decrease in 1984 of almost 30 billion dollars in contributions to private defined benefit pension plans. It is rather remarkable that net private saving actually increased as much as it did in 1984 in spite of this mechanical short-run automatic negative response of the defined benefit contribution of private saving to these rates of return.

Further, high interest rates have dramatically increased interest income which is disproportionately received by the elderly, many of whom are dissavers. Again, conclusions concerning the interest sensitivity of consumption or saving must be tempered by such features of our economy. In the long-run, we expect more saving, and then more dissaving from the working generation. The retired generation's dissaving offsets the working generation's increased saving for a while.

Two other avenues for fiscal policy to affect saving are changes in government consumption and redistribution policies between the rich to the poor if the latter are liquidity constrained or have a higher propensity to consume. Neither of these factors appears to be large enough to cause much of a change in saving (see Boskin and Kotlikoff (1985)).

I conclude therefore that public policies can and do affect private and national saving, and that by virtue of their magnitude and likely response, intergenerational redistribution policies -- explicit and implicit public debt -- are probably quantitatively more important than capital income taxation, but that the latter certainly plays some role. In any event, federal government dissaving is currently swamping any likely increase in private sector saving that could be produced by structural changes in tax policy in the near future. In order to increase our net national saving rate, we will have to decrease government dissaving.

6. Economic Policy and the Future of National Saving

There will be a natural tendency in the United States for private saving to increase somewhat as the baby-boom generation enters its peak earning years. How large this effect will be is difficult to predict for a variety of reasons. First, the generation born post-1939 appears to be saving less at corresponding ages than did those born prior to 1939. Will this effect continue as they enter the last few decades of their working lives? Further, a lower saving rate in this vintage of workers may be a reflection of reduced risks, for example, those which have been mitigated by various public insurance programs. As noted above, however, they also may reflect differences in time preference and a different set of incentives. In the government sector, the future trends are not so sanguine. The federal government will be accruing substantial liabilities in OASDI and HI. The massive surplus that is projected to develop in OASDI between 1990 and 2017 will amount to about 30% of GNP. This surplus is the primary means by which we are bringing the long-term deficit in OASDI under control. If we are unable to accrue such a surplus and dissipate it instead by increased benefits or more likely, "loaning" it to HI to cover the massive HI deficits which are projected to begin in the next decade, large public deficits in social insurance programs loom ahead in the next several decades.

Correspondingly, similar problems of large projected deficits due to economic constraints and demographic changes occur in many of the OECD countries. An important example is Japan, the world's second largest economy and the largest contributor to the world capital market. The Japanese population will be aging rapidly, and this may well lead to a decrease in the saving rate in Japan. If this occurs, the potential deleterious affects of massive U.S. government borrowing will be less easily offset by importing foreign capital.

Our policy goals should simply be neutrality toward the consumption/saving choice. While a complicated series of special provisions in the tax laws, monetary and fiscal policies, and numerous other types of government economic policies potentially affect the saving behavior of different groups, and therefore, the aggregate saving rate, on balance the pendulum has swung very far toward economic policy encouraging consumption at the expense of saving and investment. This is primarily due to massive federal government borrowing. State and local governments are also accruing large liabilities in their pension funds which are not recorded in the National Income Accounts reporting of their current surpluses. Prior to 1980, structural tax policy probably on balance contributed substantially to a pro-consumption, anti-saving and investment set of incentives. The 1981/2 tax laws redressed these disincentives substantially, although quite imperfectly and unevenly.

As we look to the future, there are two primary imperatives for economic policy to achieve such neutrality between consumption and saving. First, the federal government (and also state and local governments) should develop the budgetary discipline, or institutional rules, which generate a conceptually properly measured current services operating budget which is balanced over a span of time sufficiently long to encompass the short-term economic fluctuations our economy is bound to experience. This will require developing much better data and reporting on government investment, inflation adjustments for government assets and liabilities, etc.

Second, but less important, we should be moving toward a tax reform which levels the playing field both among types of saving and investment and between the consumption/saving choice. An income tax taxes saving twice: first when it is earned as part of income and again when it earns a return in the form of interest or dividends. We should be taking our current corporate and personal income taxes, which are really a hybrid of income and consumption taxation, and gradually move them toward a conceptually proper personal consumption tax. Various studies have indicated the likely beneficial economic impacts of doing so, and such a tax system is likely both to be fairer and eventually easier to administer (although the transition to it will cause problems). Several excellent prototypes exist for dealing with the substantial number of conceptual difficulties in such a tax reform.[19]

Recent economic policy gets a mixed scorecard in removing the distortions and disincentives to saving in our tax system and budgetary policies. The recent history of federal government deficits on the order of 5% of GNP (however improperly measured) and the likely prospect of those continuing would almost certainly insure a low net national saving rate for years to come. The Gramm-Rudman-Hollings balanced budget bill, if implemented, will sharply reduce government dissaving. While implementing Gramm-Rudman-hollings will probably cause substantial problems, the benefits of crystalizing the choice we face in getting our budget deficit under control or continuing an insidious gradual erosion of the gains in our future living standards make me not unsympathetic to it. However, numerous difficulties, including many of the conceptual issues reported above, remain. If a substantial part of the reduction in the deficit comes at the expense of government investment, our net national saving will be reduced much less than the reduction in the deficit, for example.

Structural tax reform is moving in the wrong direction with respect to saving and capital formation. While differential taxation across different types of saving and investment should be eliminated, it is less of a problem for the economy than our tax bias against saving and capital formation. Both types of distortion -- among types of saving and investment and between consumption and saving -- should be eliminated. Unfortunately, the bill passed by the House Ways and Means Committee (while perhaps producing some very modest gains in the allocation of the existing capital stock among types of investment) almost certainly will result in a worsening of the disincentive to save and invest caused by our tax system. The dramatic slowing of depreciation allowances, the elimination of the investment tax credit, and the elimination of a variety of other tax-free saving vehicles and other features will more than offset the potentially modest benefits for saving and investment of the reduction in marginal tax rates. Of course, the broadening of the tax base and the reduction of marginal tax rates will have other potential benefits.

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[19] See, for example, D. Bradford, Blueprints for Basic Tax Reform, U.S. Treasury, 1977, and R. Hall and A. Rabushka, Low Tax, Simple Tax, Flat Tax, McGraw Hill, 1982. The Hall-Rabushka plan is a very clever method of implementing a pure consumption tax. Too much attention is focused on the flat tax rate as the vehicle for simplicity. Actually, the only contribution a single rate makes for simplicity is harmonizing the tax treatment of business and wage income. The actual simplicity comes from eliminating the need for complicated depreciation schedules, inflation adjustments, reporting interest expenses and deductions. Their contribution to the tax reform debate is a "very clean" linear consumption tax.

We should be moving toward pure consumption taxation and elimination of our government budget deficit on a conceputally proper inflation adjusted comprehensive current operating basis. Spending reduction should focus on government consumption and if necessary as a last resort, tax increases should focus on consumption, not saving and investment. The likely beneficial effects of such fiscal and tax policies are substantial, but gradual and cumulative. The gradual erosion in gains in living standards potentially available to future generations of Americans caused by continuing large budget deficits and an anti-saving and investment tax system is too high a price to pay for the short-term benefits of increased current government and private consumption.

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Table 1

U.S. Net National Saving
1951-1984

	1951-60	1961-70	1971-80	1981	1982	1983	1984
Total Net Saving	6.9%	7.5%	6.1%	5.2%	1.6%	1.8%	4.0%
Net Private Saving	7.2	8.0	7.1	6.1	5.4	5.9	7.4
Personal Saving	4.7	4.7	4.9	4.6	4.4	3.6	4.3
Corporate Saving	2.5	3.3	2.2	1.4	1.0	2.3	3.2
State-Local Govt. Surplus	-0.2	0.1	0.9	1.3	1.1	1.3	1.4
Federal Govt. Surplus	-0.2	-0.5	-1.9	-2.2	-4.8	-5.4	-4.8
Memoranda: Capital Consumption	8.9	8.5	9.9	11.2	11.7	11.4	11.0
Gross Private Saving	16.1	16.4	17.0	17.2	17.1	17.3	18.4

Notes: Data are averages (except for 1981-84) of annual flow, as percentages of gross national product.
Total net saving and total net investment differ by statistical discrepancy.
Detail may not add to totals because of rounding.
Source: U.S. Department of Commerce.

Table 2
U.S. Net National Saving, 1951-1984, Alternative Concepts

Year	NIPA Net Saving	Flow of Funds	Net Saving adjusted, S_a for durables out of NNP*	NIPA Adjusted for durables S_a out of Private NNP*
1951-60	6.9	9.3	12.4	16.6
1961-70	7.5	9.2	13.6	17.8
1971-80	6.1	16.6	12.2	15.7
1981	5.2	3.5	10.8	13.8
1982	1.6	-10.2	6.8	8.7
1983	1.8	3.7	8.0	10.1
1984	4.0	NA	10.1	12.7

Source: Author's calculations.
NNP* = NIPA NNP + the rental flow from consumer durables net of depreciation + the rental flow from government tangible capital net of depreciation.

$$S_a = \frac{NNP^* - C^* - G^*}{NNP^*}$$

C* = NIPA consumption + the rental flow from consumer durables net of depreciation less durables expenditures.

G* = NIPA government expenditures plus the rental flow from government capital net of depreciation less government investment expenditures.

See text for further discussion of measurement.

Table 3
Consumption as a Percent of Adjusted NNP

Year	C*/NNP*	G*/NNP*	(C* + G*)/NNP*	C*/(NNP*-G*)
1951-60	62.6	25.0	87.6	83.4
1961-70	63.0	23.4	86.4	82.2
1971-80	65.8	22.0	87.8	84.3
1981	67.7	21.4	89.2	86.2
1982	70.9	22.3	93.3	91.3
1983	70.7	21.3	92.0	89.9
1984	69.3	20.6	89.9	87.3

Source: Author's calculations.
NNP* = NIPA NNP + the rental flow from consumer durables net of depreciation + the rental flow from government tangible capital net of depreciation less durables expenditures.

C^* = NIPA consumption expenditures plus the rental flow from consumer durables net of depreciation less durables expenditures.

G^* = NIPA government expenditures plus the rental flow from government capital net of depreciation less government investment expenditures

See text for further discussion of measurement.

Mr. SILK. Thank you.

At one point you said something that I think I have to challenge. It was that we cannot go on presumably much longer, although you didn't give a date, in piling up foreign debt. As others have said, the interest payments alone become enormous. I think it was Les who said they would be $100 billion a year by 1990 and you said that you know of no nation that has ever been able to continue piling up debt indefinitely.

Mr. BOSKIN. That was the leading economy of the world at that stage in history.

Mr. SILK. Well, I don't know how you define it, but Eddie Bernstein told me over the phone yesterday that Canada has been incurring debts continuously every year since it was born and at a fairly sizable rate. The Canadian net inflow of capital, as I remember the number—I haven't checked these numbers—has amounted to 3 percent per annum almost forever.

Now, I say this not obviously to bait you but to say is it possible, as in talking about what level of budget deficit is acceptable or sustainable depending on growth rates or whatever, that the United States could as it did through the first century of its existence roughly, be a debtor country, stay a debtor country, and at what acceptable level?

Mr. BOSKIN. There's a very important interaction between the accumulation of this debt in the long run and the stability of our budget deficit and our national debt, and that results from the fact that if Les' numbers are correct, that we're looking at a $1 trillion net negative position a few years from now and that continues to go on; think of yourself if you're a German or Japanese firm or household or financial institution investing in dollar denominated assets in the United States. Eventually, your portfolio goes from 5 percent in dollar denominated assets to 10 percent, to 20, to 30 to 40, and Professor Tobin, who won the Nobel Prize for, among other things, telling us not to put all our eggs in one basket, would I'm sure agree that eventually foreigners to continue this level of movement of resources into the United States would demand higher and higher interest rates.

And it's really very important that we get the growth rate of the economy above real interest rates—or I should say that we get in proper alignment or in stable alignment the growth rate of the economy and the real interest rate we have to pay on government obligations. It's unclear we can raise the growth rate enormously.

I also would like to say that I don't consider Canada a sufficient example because I think it's more like a State such as California in its economic relation to the United States than a large economy with modest international flows.

Mr. SILK. But it's bigger than Puerto Rico, you can see.

Mr. THUROW. Certainly. Let me make a comment here. Obviously, in some technical sense, as long as the international debt doesn't grow any faster than the GNP it can do it forever. The problem is that the international debt is doubling every year at the moment and that is a lot faster than the rate of growth of the GNP as far as I know.

Then the second problem is, one of the differences between ourselves in the 19th century—and, of course, you're asking the question that President Reagan asked the other day—and the Canadians is presumably that the Canadians now are borrowing most of that money to finance investment. If you look at what we're doing with it, we're borrowing most of it to finance either public or private consumption. So, we aren't automatically creating the assets out of which you can pay it back.

Now, the other thing you could do, of course, is you can in an equity sense sell America off to the rest of the world. In the earlier panel it was suggested selling off Federal assets to Americans to solve the problem. My suggestion there is that the Federal Government allow private corporations to charge 10 cents a mile for every car on the interstate highway system, we sell off the interstate highways and pay off the Federal deficit—the national debt and have no debt at all. Well, you could do the same thing in the international debt. You could sell all America to the foreigners, but presumably you don't really want to do that in either case. So, I think you just can't buy this idea that we can double the international debt every year.

Mr. SILK. Herb.

Mr. STEIN. Well, I recently came to a remarkable conclusion which I commend to you and that is that if something cannot go on forever it will stop. So, what we have learned about all these things is that the Federal debt cannot rise forever relative to the GNP. Our foreign debt cannot rise forever relative to the GNP. But, of course, if they can't, they will stop.

In the case of the Federal debt, there may not be a mechanism. In the case of the foreign debt, which is essentially private debt, it will stop when the rest of the world doesn't want to hold it any more. It will stop rising, and when it stops rising the dollar will decline and we will stop running this big balance of trade deficit.

So, in order to indicate that there's some problem I think it's important to indicate that the problem is not that we're borrowing from the rest of the world; the problem is that we're running the Federal deficit. Given the fact that we run the Federal deficit, the borrowing from the rest of the world is a great advantage to us and not a disadvantage to us.

Mr. THUROW. Well, Herb, it depends a lot on how the lending stops. Suppose the foreigners tomorrow morning didn't in Michael's sense just say it's risky, I demand a higher risk; they did to us what we did to Mexico on August 13, 1982. The lending stopped. That would be a very painful transition. No question the market is going to stop the lending at some point, but the question is: Does it stop it in a smooth relatively benign way or does it stop it with a smack that is not to be described by anybody as smooth and benign?

Mr. STEIN. Let's say that that is a question, but the mere fact that it cannot go on forever does not indicate that there's a problem. Now, if you can demonstrate that there's a very high probability that the end will come in this disastrous way, then you have a problem. But we haven't demonstrated that.

In fact, we have now demonstrated that we could have a decline of the dollar—it used to be said that when the dollar stopped rising and first began to decline, then it would decline with a crash. Well, it's declined 20 percent or so. We do not seem to regard that as a crash and it does not seem to be precipitating any crash.

So, certainly, I agree that there are uncertainties here as in everything else, but let's not make the uncertainties too certain.

Mr. SILK. As the sergeant used to say on Hill Street Blues, "Do it to them before they do it to you."

Now, I'm going to turn to the questions from the floor. We have enough of them so that we could take over the time and space of the next panel, but I do want to continue with the first question that bears on the issue we have just been discussing, what to do about the foreign debt situation.

The question is, could the panel present a scenario for servicing the United States foreign debt after it reaches its peak? It says, what will that peak be? They don't have to answer that question. That question comes from Warren Huntsberger of American University. Who would like to tell us how to service the debt when it gets to at least a trillion or maybe a lot higher?

Mr. THUROW. Well, you've got some arithmetic problems here. It depends on when the lending stops but take any number you like. Suppose the lending basically stops when you run up debt so you owe interest payments of $75 billion a year. That means, technically speaking, you've got to have a surplus on current account of $75 billion a year to pay what's demanded on capital account. That means you've got to sell that many goods and services to the rest of the world. So, if at the moment you're running a deficit on the current account of $150 billion and you have to go to a surplus of $75 billion, then you've got to make a net swing of $225 billion in those international accounts.

Now, depending on how many jobs you think equal how many dollars, but on average in the American economy a million workers equal about $40 billion worth of output, that means somewhere out there in that whole world economy you have to make enormous microeconomic brick and mortar structural change.

The world has to change from a world where the United States runs a deficit of $150 billion to a world where the United States runs a surplus of $75 billion and, granted, McCracken made the point earlier that economies are somethimes more robust than we sometimes expect and make these changes easier than we sometimes expect, but I suspect that a $225-billion swing would not be somethng the world economy would do easily in a short run period of time.

Mr. SILK. Herb, I'm going to let Jim Tobin go ahead of you.

Mr. TOBIN. Well, I think the way it would all work out is that the exchange rate will move eventually to the point that we do have an export surplus which pays for the interest on the debt. Since that exchange rate is going to be lower, the terms of trade are going to be against us compared to the time at which we incurred the debt. That is some loss to the Nation.

I do want to point out that the country needs to have the dollar go down, probably still further than it has. There's still slack in the economy, and a lower dollar will improve our competitiveness, giving us a welcome export demand stimulus.

There is no reason for the Federal Reserve to offset that unless we get to such a low rate of unemployment that we are in the inflationary danger zone again.

So, I think the idea that the Federal Reserve will have to defend against a fall in the dollar should it occur faster than someone thinks it should is a mistake. There will be a transitional period during which the exports and imports will not respond right away to the lower value of the dollar. This is known in the jargon of the profession as the J-curve of adjustment to a change in the exchange rate. During that time there seems at first glance to be a deep problem. You have less foreign capital net coming in, and at the same time you still have a trade deficit. But the accounts have got to balance some way; the capital account has to be the mirror image of the current account. So, how will it balance? It will balance by the fact that the dollar will go to a point where people think it's going to rise again, and then the attraction of being in dollars and sending money to finance our transitional trade deficit will come not from high interest rates in the United States but from the views of Americans as well as foreigners that the dollar is going to rise in value.

The greatest danger in the next few years in stabilization policy is that an excessively tight monetary policy is prematurely undertaken to "defend the dollar." That shouldn't be done.

Now, when we do get a correction of the trade deficit and then if we are at a reasonable level of employment and on a GNP path that we can't go beyond without unaccepable risk of accelerated prices, then the Federal Reserve would have to raise interest rates to make room for a trade surplus or lowered trade deficit by an offsetting reduction in domestic demand.

We are not there now, so they wouldn't need to do that now.

Mr. SILK. I have another question here that relates to monetary policy and it is directed specifically to Jim Tobin from Paul Davidson who is a professor at Rutgers.

Should the Federal Reserve set its monetary policy based on targeting real GNP growth or nominal GNP growth? Should monetary policy also take into account the exchange rate? If so, if exchange rate targeting is incompatible with the GNP target, which should give?

Mr. TOBIN. Nominal GNP targeting—that is having monetary policy guided by some temporary one-year goal for nominal dollar GNP—would be an improvement over the previous regime in which the Federal Reserve was setting and trying to abide by targets for M-1, M-2, M-3 or whatever.

It couldn't be just real GNP without some attention to what's happening to prices because the Federal Reserve couldn't say that, regardless of what happens on the inflation front we will have 4 percent growth in real GNP in 1987. I don't think that that should be done.

Maybe some different way of weighting the price and real GNP components of nominal GNP would be better than just taking dollar GNP as the target. However, that's more complicated. We might settle for 1-year targets for nominal GNP as an improvement on the way policy used to be done. The Federal Reserve has been moving in this direction and, as I suggested in my remarks in my paper, Congress should encourage the Fed to move toward setting monetary policy in relation to variables that really matter instead of in relation to intermediate monetary constructs that don't really matter.

I do not think that Federal Reserve policy should aim at the exchange rate in the same way as toward the domestic objectives I've just talked about. But I do think that better coordinated macro policy among the major economies would be a good idea. That might include occasional exchange rate interventions. Other than that, I would be guided by the domestic objectives.

Mr. **Silk**. Did anyone else on the panel want to comment?

Mr. **Stein**. Well, I'd like to say a little stronger word for nominal GNP targeting than I think that Jim has in mind, because he talks about targeting for 1 year at a time which I assume means that you would adjust your nominal GNP target in the light of your changing views of what are the potentials for real growth and what's happening to the price level. That seems to me a very dangerous kind, of course.

It seems to me the great advantage of nominal GNP targeting is that you create a stable nominal demand situation to which the economy can adjust and the economy will then tell you what is the achievable rate of real growth because the achievement of the real growth will not be hampered by the absence of a stable and predictable rate of growth of nominal GNP.

I think that in the past we got the problem of inflation in large part by aiming at some unemployment and real GNP targets which were always set in a very ambitious manner which justified continuously expansionary monetary policy and which over the course of 15 years got us up to a very high rate of inflation. If we want to avoid that again, it seems to me that we ought to commit ourselves to some rate of growth of nominal GNP to which the economy can adjust and to which real output can adjust.

Mr. **Silk**. It suddenly occurs to me we've got some more talent to my right here and I haven't asked if it has any comments or questions or other observations on the proceedings thus far.

Senator **Sarbanes**. I have only one point I want to make here. Alan Blinder asked a question earlier; he was entitled to an answer from our side and he didn't get it. He asked why doesn't the Congress do these things, because it's so clear economically what to do and yet they seem to be so difficult politically.

I would only say this to him: Imagine an exam question that begins by telling students, "Look at current economic circumstances and address the question of what fiscal policy the National Government should follow, "and then stipulates, "In considering this question accept the hypothesis, as unrealistic as it may be, that the President is rigidly opposed to any increase in taxes, and any cut in defense expenditures, and bear in mind also the leadership role of the President in our political system, the power of the Presidential veto and the popularity of the President." If the question concludes by asking, "What do you think would happen?" And a student replies, "Pure chaos," I think that would have to be judged an A answer. And I think that's exactly where we are.

[Applause.]

Mr. **Silk**. I have a question here which is from the floor but I'm delighted to receive it because it has asked me to ask Loen Keyserling, who was Chairman of the Council of Economic Advisers during the Truman administration, whether he as a participant in the Employment Act believes that full employment and growth were not—I think the sense of it is whether they were not the most important objectives of the act and whether they have not been neglected. Leon, where are you sitting?

Mr. **Keyserling**. What do you want me to do?

Mr. **Silk**. Would you like to come to a microphone?

[Applause.]

Mr. **Keyserling**. First of all, since I have accidentally gotten here, I want to begin by commending Chairman Obey for his statement of objectives of national economic policy with superbness which I have rarely heard. I think his statement that growth, which means also full employment, and equity or something similar to that—justice—and opportunity are the three basic purposes of any economic system are unalterably right.

What bothers me is that instead of an empirical examination of what has been happening during these 40 years of experience for which this meeting is a wonderful opportunity, there's really been no thought during this discourse on economic policy to any real examination of what happened and why.

Now the easy answer that we frequently hear is that it's relevant because times are different, but times are always different. Times were different then. But the whole basis of scientific progress and the application of any discipline is learning something from what's happened and not saying that Pasteur or Einstein are irrelevant because things have changed and some things are different.

Now a good example of this which I will cite for a practical reason is that I heard it up here—I don't know just from whom—that there is not really enough attention to the problem of economic growth under the Employment Act. This could not have come from any study of what happened because some of you half as old as me will remember that the thesis which the first Council of Economic Advisers primarily injected into the whole vocabulary of economic thinking was an expanding economy and that everything that we proposed was based on specific quantitative goals for our economic growth which the goals were employment and economic equilibrium and the relationship between investment and consumption on which everything else was based.

I would also say that the studies since then add nothing but continuing the same process. Now this isn't important in order to give any kudos to what was done 40 years ago. It is important to raise a question about the whole theory that we can't learn very much from what's happened over 40 years. I think we can learn an awful lot from it and I do not think the quest is something new on the ground of what is right and what is needed and what has been proved.

The fundamental problems of the economy—employment, growth, poverty, justice—the fundamental problems are the same and the fundamental problems were the same in the 1920's but the wrong answers were found and the fundamental problems were the same during World War II. The first Councils were effective not because they said World War II was not relevant because it was over and we hoped it would never occur again, but with proper modifications we used exactly the approaches and the formulae and the values that were applied during World War II and there was a great similarity between what we did after World War II immediately and what was done then if you look at them in these fundamental terms.

So I just appreciate the opportunity for making a plea not to be so blithe about we know it all today and tomorrow. I used to ask my staff how it was that they always could tell me what was going to happen 2 years from now but could never tell me what happened last year. Let's look a little at what happened last year in order to determine where we should go now.

[Applause.]

Mr. SILK. Thank you very much, Leon. Well, we are approaching the end of this session. I've got a stack, as Paul McCracken said, 6 inches high which we are not going to get through today. I think it was particularly good to have Leon at the end to remind us that heart and the past and all that count for something.

In my own terms I want to say I hope that you will be here for the afternoon session because the moderator then will be an old colleague of mine, Ed Dale, who distinguished the coverage of the New York Times in this town for a long time and still distinguishes the spokesmanship of the Office of Management and Budget. And I think it's a great tribute to the press to treat Ed as a member of the press. So we will have Ed as a moderator this afternoon.

With that, I turn the microphone back to our chairman.

Chairman OBEY. Thank you very much, Leonard. I'd like to thank you and the panel and Leon Keyserling for your comments this morning.

Let us now break for lunch. We want to resume as sharply as possible at 2 o'clock. We have two panels this afternoon, one on productivity, and then I think a fascinating panel relating to much of what Leon Keyserling said in his remarks, creating an economic system which reflects American values.

[Luncheon recess.]

LUNCHEON: INVESTMENT, DEBT, AND THE AMERICAN ECONOMY

Chairman OBEY. Congressman Chalmers Wylie was supposed to preside at this luncheon today. Chalmers has been ranking Republican on the House side on the JEC. Unfortunately, he found out about an hour ago that his mother-in-law was having certain problems at the hospital and he had to leave and so he asked me if I would read his remarks as well as his introduction of our two speakers today. So if I sound like a Republican for the next 5 minutes, keep in mind it's the first and only time it will ever happen.

Before I introduce our guests I again would like to introduce those at the head table: Senator Sarbanes from Maryland; Mrs. Richard Bolling, Mr. Richard Bolling—we'll leave the next two—Congressman Jim Scheuer and Leon Keyserling, who I know all of you know and who ended the meeting this morning on quite an appropriate note.

What we're going to do—Mr. Sprinkel has to be up at the White House at two. There's a fellow by the name of Reagan who wants to see him. So what we will do is have him speak first and take a few questions and then we will move on to Mr. Rohatyn.

Before we do that I would like to read Chalmers Wylie's remarks. Dispensing with what he said about me, which is eminently dispensable, he goes on to say that this is truly an altogether splendid two-day event.

Our luncheon speakers today are very well known spokesmen for economists and investment bankers. Mr. Beryl Sprinkel is currently Chairman of the President's Council of Economic Advisers and Mr. Felix Rohatyn is managing director of the New York and Paris investment banking firm of Lazard Freres.

The topic they have been asked to clarify for us is the current state of health of the American financial system.

Continued economic development requires savings for business to invest in finding and developing new opportunities. Recently concern has arisen that changes in the American financial system may have unfavorable effects of actually hurting the transfer of savings into real investment and new business venture.

This concern takes several forms. For example, some observers are alarmed about a trend toward increasing debt in the balance sheets of American corporations. This worry is based on a feeling that higher debt-equity ratios may increase financial vulnerability of corporations and bankruptcy and therefore inhibit their ability to undertake new investment. Others find problems in what they see as a change in attitude by investors. In this view there is some thought that short-term speculative objectives are replacing longer term goals and that this change may have the effect of forcing corporate managers to concentrate efforts and resources for short-term gains at the expense of long-term investment.

Still others feel that serious questions are raised by the rising rate of mergers, acquisitions and takeover bids absorbing unfavorable amounts of capital and reducing savings flows into more productive long-term investment.

In addition, in some quarters there is a sense that flows of international capital is disrupting the patterns of international trade.

In addition, the accumulation of debt by third world countries is recognized as a source of strain on the American financial system along with that of other countries as well.

They are all big questions and we know we won't get complete answers to all of them in 20 minutes allotted to each of our speakers. However, we are confident that our questions are addressed to two of the most knowledgeable people in the world today. I will skip what he says about the format and then go on to his introduction of Beryl Sprinkel.

Our first speaker for this session is Dr. Beryl Sprinkel, Chairman of the President's Council of Economic Advisers. His job is to advise the President on economic matters, take on other assignments by the President, and produce the Council's annual economic report to the President. On several occasions he has been described as the second most important economist in the world today. Since we have not been able to find out who the one more important economist is, we are proud and honored to have Chairman Sprinkel present his views to us.

Chairman Sprinkel received his doctorate in economics at the University of Chicago in 1952, the same year he joined the Harris Savings & Trust Co. in Chicago. He stayed with Harris Trust for 28 years where he rose to the office of executive vice president and chief economist. During this period he was an active participant in most of the economics profession's national organizations for business economists and he was a frequent consultant of various Government agencies and congressional committees.

As a nationally recognized monetarist, he was a member of the so-called Shadow Open Market Committee from which he has now resigned. He jointed the Reagan administration in 1981 as Under Secretary for Monetary Affairs in the Treasury Department and since early 1985 has served as the chairman of the President's Council of Economic Advisers. For 5 years now he has been a hands-on professional in an extraordinarily wide range of official activities with major implications for domestic and foreign financial markets. It seems likely that he now has one of the two most accurate assessments today of world financial markets from the point of view of the U.S. Government. In this case as well, we are not entirely certain who has the other expert view but it is my honor to give you Chairman Sprinkel. And if Chalmers were here I would say, Chalmers, I couldn't have said it better myself.

[Applause.]

PRESENTATION OF BERYL SPRINKEL

Mr. Sprinkel. Thank you, Chairman Obey.

I am delighted to have this opportunity to discuss some aspects of the American economy on this 40th anniversary of both the Joint Economic Committee and the Council of Economic Advisers.

Over this 40 years I believe that American economics and economic policy making have made great strides forward. To be sure progress has not been continuous or smooth, but on the average I think the record is quite good.

Since 1946, for example, per capita real disposable income has more than doubled. The Joint Economic Committee I feel sure has played an important role in this progress and I hope that my predecessors at CEA did the same.

Today I have been asked to discuss investment, debt and the American economy.

The role of investment as an engine of economic growth is certainly widely recognized. Over the postwar years capital formation has been a major source of growth in labor productivity and per capita income. To a large extent, that growth has been financed by credit. The great expansion of credit markets in the United States and the general stability of those markets has been a major facilitator of economic growth. Yet, there is currently a great deal of concern about the debt problem.

Debt itself need not be a problem. However, debt can readily become a problem in an unstable macroeconomic environment. The debt problem reflects the revaluation of the physical assets and income streams that underly outstanding debt. Those revaluations occur as a result of macroeconomic instability.

What are the primary sources of this macroeconomic instability? It seems to me that over the last 40 years there has been two serious types. No. 1, of course, is recession, and the deeper and more serious unanticipated changes in the rate of inflation.

The isolated, though prominent, problem areas in farming and energy and real estate and with LDC lending are all associated with bad policy that led to an unstable economic environment. In particular, the rise in the inflation rate in the 1970's led to serious distortions of relative prices and set in motion expectations about the future course of the general level of prices. In that environment a number of bad decisions, in retrospect, were made.

Both lenders and borrowers entered into agreements based on expectations that inflation would continue. In some sectors the behavior was based on the expectation that land, energy, commodity and other real asset prices would continue to rise rapidly as they had for several years.

With the decline in inflation and inflationary expectations, all real debt burdens rose. However, when coupled with declines in real asset values and income streams the problems in some cases became severe. I do not only mean that individual creditors and debtors lacked perfect foresight. We never have perfect foresight. In an inflationary environment uncertainty and financial risks rise and often savers lose money. With disinflation debtors suffers serious capital losses.

I see no way for individuals to avoid the arbitrary redistributions associated with unexpected changes in inflation. Nor do I see any reason for the Government to create such policies that generate such results. With the Government I think the objective should be—and I think you will all agree on this—to promote sustainable growth and a predictable environment at low to zero rates of inflation. It's important that the Government learn what it can and what it cannot do to improve economic performance.

We want to avoid inflation. This is, of course, the unique responsibility of the central bank and we want to avoid those inappropriate policy decisions that in the past have led to recessions and make certain it doesn't occur from here on in.

Some of you may not agree with the next thought that I would like to present. I think we have learned that fine tuning of monetary or, for that matter, fiscal policy should be avoided because policy making lags are likely to induce unintended, destabilizing effects on the economy. And I like to think of these lags as essentially being three.

One, the observation lag. We have just gone through such a period when there was great disagreement not only in Washington but across the Nation as to whether the economy was accelerating or whether it was not. Until you know for sure what's happening to the economy that you may want to affect, you can't very well take an action. But even if you know, as I think most of us know now, that the economy is in fact accelerating, there is still an execution lag. With fiscal policies that may take a long time and the monetary policy not quite as long.

Then the impact lag. You do not get immediate results. Impacts are distributed over a considerable period of time. Sometimes the short run effect tends to be the opposite of the long run effect. For all of these reasons I think we cannot expect that discretionary monetary fiscal policies will bring us the agreed upon objective of sustainable growth at low inflation.

Let me turn to the fiscal area for a moment. If we aren't going to use fiscal policy for fine tuning, does that mean it's useless? Of course not. The continuous path that we have been on in the last several years leading to higher and higher levels of Government spending as a share of GNP and resulting in large budget deficits despite the recovery in economic activity are, in my opinion, a serious problem.

I believe the rise in spending has occurred because benefits from particular spending programs are highly concentrated and the elected Congress hears from these parties whereas the costs are widely dispersed and they don't hear as frequently from the taxpayer who is ultimately going to pick up the tab.

We believe that rising Government spending like we have, unfortunately, experienced in this administration and in prior ones crowd out private use of resources, creates uncertainty about inflation and prospective credit market demands, misallocates resources and slows economic growth. From my point of view, the right approach is to restrain spending and not engage in activities that make it more difficult to grow, such as raising taxes.

We will take—and I believe Congress will take—Gramm-Rudman-Hollings seriously and adhere to the deficit path that has been prescribed. President Reagan's budget will do so and I certainly hope that Congress will do so. This will help to reduce inflationary expectations further and thereby reduce interest rates. It can help to contribute to economic growth and, incidentally, probably improve the balance of payments.

In our view, we need to cement the potential gains that we hope to get under Gramm-Rudman by eventually passing—and the sonner the better—a balanced budget amendment to the Constitution with spending limitations.

Let me turn to monetary policy for a moment. We should provide a monetary environment that promotes growth, that does not bring about great volatility in the action of a monetary authority. It's our view, as I think you all know, that the best risk-minimizing strategy is to encourage stable and moderate growth in the money supply.

We should also give greater attention to the microeconomic environment. In the tax reform proposal that we have been working on, there's been an effort to eliminate many distortions that are in the Tax Code that promote debt financing over equity financing. We tried in the first version. I must say that there was much opposition from specific interest groups. I suspect that's why it was cut back in the version passed by the House Ways and Means Committee. Nonetheless, I think it's a highly desirable objective and we should continue to work along that line.

Furthermore, there's been a strenuous effort to avoid those tax incentives that tend to favor some industries vis-a-vis other industries so that we can get a more rational and efficient allocation of scarce investment resources.

We believe deregulation of the credit markets have improved credit allocation and the availability of credit. Additional flexibility has been provided by deregulation, thereby making it possible for these markets to be more flexible and able to adjust when the inevitable shocks occur.

We need further reforms in that area, especially with respect to deposit insurance so that we can have the proper incentives while maintaining the safety valve of the lender of last resort. Finally, I think it's high time to work hard to reduce the role of Government as a guarantor of private debt.

Let me say strongly that we do not believe we can solve these debt problems or that we should solve these debt problems through going into another period of accelerating inflation. Renewed inflation will only compound the uncertainty in the financial markets and further distort relative prices. The capital gains and losses have already occurred. We made good progress in getting inflation expectations down. Another round of inflation would only initiate another round of arbitrary reallocations of capital and I think would contribute to generating another unstable situation.

Finally, I do not believe that we can solve the debt problem by increasing the regulation of financial markets. Current credit problems were not caused by deregulation. Heavy-handed restrictions on credit allocations will lower efficiency, not improve efficiency. Regulations impede the flexibility needed to adjust to changing circumstances.

Where does the private sector fit into this role? As I see it, the role of the private sector is to allocate credit efficiently on the basis of economic criteria and, of course, to reap the rewards of successful investment strategies as well as pay the price for unsuccessful strategies.

Private credit markets can provide a very useful intermediation mechanism between savers and investors and thereby make a significant contribution to achieving economic growth. It can allocate scarce credit efficiently to investments yielding the higher expected rates of return. It can provide a flexible, dynamic system that will help weather shocks to the system.

From my point of view, the private sector should not expect the taxpayer to pick up the tabs for losses on bad loans. They should not expect to be shielded from the rigors of competition by asking for additional Government regulation. Whenever the Government intervenes in the credit markets to pick up the tab on bad loans or to regulate operations, the incentives to allocate credit efficiently are seriously weakened.

The economic fundamentals that define the appropriate roles of the Government and the private sector are equally applicable to creditors and debtors. As I mentioned earlier, underlying the debt problem are revaluations of assets or earning prospects. For many LDC's the problem on the investment side of the coin are very real. Poor micro and macro policies in many cases have led to reduced growth prospects. In addition, a portion of these loans to those countries were, unfortunately, not invested in economically viable investment projects or not used for investment projects at all.

Let me turn briefly to investment in the United States. The record of U.S. investment over the last 40 years is one of great accomplishment. The capital stock is now estimated to be three and a half times as large as it was 40 years ago. The rise in capital per worker has increased the rate of growth of GNP by more than a half percentage point per year.

It is important to maintain the incentives for capital accumulation if we expect to maintain continued growth in output. Presently, real fixed business investment as a share of real GNP is at a record level for the second year in a row. We have seen large increases in investment in high technology areas and a major decline in the relative prices of investment goods. For example, between 1972 and 1984, investment in computing equipment increased from less than $1 billion to more than $22 billion in real terms. Since 1982, investment prices have fallen 10 percent relative to the overall GNP deflator. These are highly positive developments that should be maintained.

In conclusion, over the past 40 years we have seen a major improvement in the standard of living of Americans. Over the same period we have seen major improvements in the science of economics and applications to economic policy making. The lessons we have learned have been both positive and negative. We have learned what we can and cannot do. What we can do is to provide a stable macroeconomic policy environment, including a reasonably stable general price level that is conducive to informed savings and investment decisionmaking.

We have learned how to apply the principles of microeconomics to the formulation and execution and evaluation of fiscal and other policies. We have learned the importance of maintaining proper incentives. We have learned these lessons, but implementation has at best been uneven.

On the negative side, I think we have learned that fine-tuning of fiscal and monetary policies does not work. On the fiscal side, many economists now argue that fiscal policy doesn't matter for macroeconomics stabilization. For my part, I think that automatic stabilizers may be helpful and while discretionary fiscal policy does not appear to be a useful countercyclical device, when aimed at long-term goals such as promoting growth through enhancing productive incentives, fiscal policy can then be useful.

On the monetary side, it should be clear that not enough is known about linkages and forecasting is and will remain sufficiently inexact to prevent discretionary monetary policy from being very useful. A risk-minimizing strategy is to be preferred. I believe that means the maintenance of stable and moderate monetary growth.

Over the past decade or so the clearest lesson is that increases in the rate of inflation and the inevitable subsequent declines can be very painful for Americans as a whole and particularly painful for specific sectors and markets.

The solution to these problems is not a general reflation or a series of further Government interventions in these sectors or markets. The solution is to create and maintain a commitment to stable macroeconomic fiscal and monetary policy and to minimize the distortions Government policy induces in private market behavior. Thank you.

[Applause.]

Chairman **Obey**. We do not have time for a lot of questions but let me ask if there is one question burning anybody's mind for Dr. Sprinkel before he leaves. Does anybody want to ask him a question?

A **Voice From Audience**. I was just wondering if Mr. Sprinkel thinks the Baker initiative will significantly change the administration's attitudes toward international economic policy? A lot of people think that it will.

Mr. **Sprinkel**. Well, my view is that it is in line with the basic policy that we have been following from the beginning.

Chairman **Obey**. Would you repeat the question?

Mr. **Sprinkel**. The question was, is the Baker plan a major change in economic policy with respect to international debt problems. I believe that's essentially the question.

The answer is, mostly no. From the very beginning we have been attempting to encourage the kind of market adjustment in those countries that will make it possible for them to grow. I think Secretary Baker was able to enunciate this concern about economic growth more effectively than has been done in the past. Many have concentrated only on the additional money that might be made available under the Baker plan, but you have to read all the print, and the print says very clearly that this is conditional on the adoption of growth oriented micro and macro policies in the countries receiving this financing.

Now all of us know long run there have to be other solutions. Longer run, once we can get the growth going, it's extremely important to encourage more equity financing in the LDC area. This means the return of capital that has flown elsewhere, especially to the United States. It means providing a greater return adequate to encourage other investors to aid in the great potential for economic growth that exists in most of those countries. It also means not using short-term financing for making long-term investments.

Those are all very worthy longer-term goals, but in the meantime, we do have a debt problem. And the question is, can we proceed in a way that will provide additional credit at the time those policy changes are being implemented?

Chairman **Obey**. Thank you. Good luck at the cabinet meeting.

[Applause.]

I should note if you are interested in minor sidelights of history, the room in which we were meeting this morning is the room in which the conference between the Senate and the House on Gramm-Rudman began and this is the room where it ended. I don't know what that says about our conference but it does put things in perspective.

Mr. Felix Rohatyn, our second distinguished speaker—and again I'm reading from Chalmers Wylie's introduction—Mr. Rohatyn started out his adult life on the path of becoming a physicist as a major field of study at Middleburg College in Vermont. He took a temporary job with the investment banking firm of Lazard Freres to have some freedom to clarify his career objectives. Over 30 years later, he's still with Lazard Freres where he deals with issues nearly as complex as any that are likely to have challenged him as a physicist.

He is known as a person who accomplished the financial tasks involved in the creation of International Telephone & Telegraph. IT&T is perhaps the prototypical corporate conglomerate. In short, he knows first-hand the intricacies of using corporate debt to purchase the stock of a company being taken over in corporate mergers and acquisitions.

More recently, he's been widely acclaimed as the chief architect on two occasions on the rescue of New York City from the brink of imminent bankruptcy and still remains chief of the New York Municipal Corp.

The combination of his expertise in both corporate and Government worlds and his ability to seek both opportunities and dangers while still producing constructive positive results for the benefits of all makes him a most compelling expert for our symposium. Mr. Rohatyn.

[Applause.]

PRESENTATION OF FELIX G. ROHATYN

Mr. ROHATYN. I'm always somewhat amused when I hear about the constitutional amendment to balance the budget and it occurred to me that you might do something constructive by combining it with the school prayer amendment and having all the school children in the country pray for a balanced budget every night. [Laughter.]

I would like to talk to you about the real world in which I live, which is a world of takeovers, of mergers, and of speculation at a level that I haven't seen in 35 years in business.

A few days ago the Federal Reserve Board adopted a rule to limit more extreme types of junk bond takeovers by applying the margin rules to a bid by a shell corporation. This rule is largely symbolic since it will affect relatively few takeovers, is easily circumvented and is aimed at the most extreme cases of leverage. The reaction was stupendous. Every agency and department of the Federal Government attacked the Fed and Paul Volcker as if they had come out with a plan to nationalize the economy. Editorials screamed in the Wall Street Journal and many others, summarized by the following excerpt from a full page editorial in the New York Post:

> Properly interpreted, then, the effects of this improper new rule will be to curtain the rights of stockholders, to reduce the value of their investment by reducing the number of potential buyers, to encourage foreign ownership of U.S. corporations, to damage the financial services industry, to remove an important incentive for corporations to use their assets efficiently, and to make the economy generally more sluggish.

The only thing left out here was chastity and some other things.

The only rational interpretation for this dramatic over-kill was that our most responsible financial leader, Paul Volcker, was being forced out Chairman of the Fed in order to promote and protect the most extreme kind of unfettered speculation seen in the country since 1929. Fortunately for us, Paul Volcker stood firm; how long he can last under these circumstances is an open question. The New Deal is dead; so are the Fair Deal and the Great Society. However, the Casino Society is here and it is here with a vengeance.

I have seen the evolution of mergers and takeovers from the conglomerate merger era of the 1960's through the growing acceptability of large, hostile takeover bids during the 1970's, to the current wave of huge transactions, which offensive and defensive tactics that often go beyond the norms of rational economic behavior. I am not here to argue against the ability of corporations to make acquisitions or to reject being acquired. Takeovers do not have to be friendly; they have to be fair and they have to be soundly financed. Current takeover tactics, both in the legal and financial area, run counter to those principles.

Arguments for new or additional regulation or legislation should be based on national interest issues. The issues involved here are two-fold:

(a) The integrity of our securities markets;

(b) The safety of our financial institutions.

They are both jeopardized by what is happening today as a result of excesses in connection with takeovers.

These excesses, let me hasten to add, are not limited to the takeover field. They are part of a general pattern of speculation in securities, commodities, currencies, et cetera. They are part of a trend of excessive risk-taking on the part of financial institutions seeking performance at the expense of safety. They are the result of a climate of rapid deregulation with inadequate preparation as to the results in certain areas.

A series of events is eroding the climate of confidence required of our financial institutions. Among these was the financial collapse of several Government securities trading firms which led to crisis in the Ohio and Maryland savings bank systems. The financial collapse of the Penn Square Bank which led to the quasi nationalization of the Continental Illinois Bank and the demise of the Seafirst Bank. The repeated credit scares of Third World borrowers. Every one of these events shakes the confidence needed by our financial system. They are, however, only the tip of the iceberg. Our banking system is still exposed to large risks. Many are under the illusion that the Third World debt problem has been resolved as a result of a series of rollovers; recent events in Argentina, Brazil, and Mexico with a combined external debt of $250 billion may create a rude awakening. Elsewhere, if the price of oil were to drop by 20 percent, not unthinkable under present circumstances, the problems of banks with large energy loans would be compounded by the problems of large oil companies so elegantly restructured as a result of takeover raids and greenmail. To the trillion dollars of Third World bank loans, we have to add the dramatically increased use of debt, both conventional debt and junk bonds, in all types of takeovers and leveraged buyouts and the risk involved if we were to enter a serious recession. One does not have to be Cassandra to be concerned about the safety of our financial institutions and to their vulnerability to sudden jolts.

By the end of 1985, American corporations will owe a total of $1.56 trillion, the highest in our history. After adjusting for inflation, debt has grown a 8.69 percent per annum in 1984 and 1985 compared with 2.7 percent from 1975 to 1983. Corporate debt exceeds total net worth by 12 percent. Total borrowings now represent 81 percent of the external sources of funds of corporations compared to 56 percent in 1975. As a result, corporate debt has replaced equity financings with stocks as a percent of external funds declining from 35 percent during 1975 to 14 percent currently. American corporations are far more vulnerable coming out of the 1980–1982 recession than they were after the 1974–1975 recession. Since 1982, cost of servicing debt has been absorbing 50 percent of the entire cash flow of corporations while during the 1976–1979 recovery the cost averaged only 27 percent of cash flow. The combination of deflation, deregulation and a strong dollar, make this a very dangerous equation.

In the securities markets, especially in the takeover field, we also find troublesome excesses. Over the long run, the capital markets self-correct, but sometimes abuses become so widespread that the markets must be helped by legislation or regulation. Today, that is the case in respect to mergers and takeovers. The abuses fall into several general categories:

(a) Unequal treatment of shareholders as part of offensive or defensive corporate actions;

(b) Unsound financial structures as a result of excessive leverage;

(c) Destabilizing impact of large-scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers, and the market volatility created as a result.

I would like to examine each of these briefly.

(a) The basic concept of our securities laws, whcih have been the basis for the worldwide appeal of our securities markets, has been full disclosure, nonmanipulation, and equal treatment of all shareholders. The most basic elements of stock ownership, that is, equal voting rights and equal equity ownership for all common shareholders are now under attack. Both the techniques of current takeovers as well as concurrent court decisions undercut these concepts. For instance, the NYSE is under pressure to permit the listing of common shares with unequal voting rights; and the recent Unocal decision in Delaware permits, in certain cases, unequal payment among common shareholders.

In tender offers, two-tier takeovers bids heavily favor professional traders to the detriment of nonprofessionals. Bids that are made subject to financing, in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and short-term traders create speculative accumulation which, in the parlance of the trade, put the company into play. Whether the result is greenmail or a third-party mergers, the result is the same—a large profit for the raider, at minimal risk.

Because of these tactics, defensive maneuvers have been devised that are equally damaging to shareholders. The payment of greenmail is the most obvious and, in many ways, the most old-fashioned of these maneuvers. Selective repurchase of stock, lock-ups, crown jewel options, shark repellent and poison pills—there's a whole James Bond array here—all have been designed to enable managements and boards of directors to interpose themselves between the shareholders and takeover bids. These tactics have been used, sometimes indiscriminately, against bona fide bidders as well as against the more pernicious types. In some of the more extreme cases the courts permitted the target companies to selectively repurchase their own shares from some but not all shareholders. The result, in many cases, is to find companies burdened with excessive debt and their remaining shareholders badly damaged.

As a result of this activity, financial structures are seriously eroded. I have mentioned several examples of companies which, in order to remain independent, have depleted their equity and taken on excessive debt. Several of the largest takeovers were brought about as a result of raids, financed by junk bonds, on the target companies which we then acquired by third parties. A large part of the oil industry has been badly damaged as a result. The mergers of Chevron-Gulf, Occidental-Cities Service, Mobil-Superior, all occurred as a result of raids or the threat of raids. The deterioration in their combined balance sheets has been dramatic. The premiums received by the acquired shareholders have been paid by the debt of the acquiring companies and, ultimately, by their shareholders. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs. In the meantime, as a result of their high levels of debt, they could be in serious difficulty in the near term if the price of oil continues to decline. If one were to write a scenario about how to get the United States into trouble as far as energy is concerned, it would be hard to improve on what is happening.

It is in the area of large takeovers that the junk-bond phenomenon is particularly hazardous. High-yield, unrated debt, in reasonable amounts, is a perfectly acceptable financing vehicle for many companies ineligible for investment-grade credit ratings. It is a different story, however, when this type of debt, in the billions of dollars, is used to substitute for equity in the takeovers of very large companies.

The risk in this type of operation is two-fold. First, in the actual security of the paper. If the takeover is successful, the servicing of very high levels of debt, at rates of interest in excess of most targets return-on-investment, requires significant asset dispositions which may not always be possible or desirable. It is an approach that also completely fails to take into account the fact that a large corporation is an entity with responsibilities to employees, customers and communities, which cannot always be torn apart like an artichoke. The alternative to a breakup requires significantly improved operating performance which is very often much easier said than done. Indeed, in loking at many of these raids, one is left to wonder if the intent is really to acquire control or simply manipulate a third-party takeover in order to make a profit with little or no risk.

The second element of risk in this type of paper is liquidity. Much of this paper is privately placed, among a small group of private investors initially, and subsequently to financial institutions such as savings banks, insurance companies and pension funds. Over the last several years, $75 to $100 billion in junk bonds have probably been placed. In many instances, no large-scale, liquid public market exists in these securities and purchases and sales are handled through private transactions. Many of the investing institutions are in financial sectors under considerable pressure at this time.

To protect themselves against this type of takeovers, companies have begun large-scale restructurings of their own whereby they assume significant amounts of additional debt in order to shrink their equity and increase the price of their common stocks. ARCO and Litton Industries are the most recent example of this trend, the latter shrinking its capital base by more than one-third. Whether in the long run, this is sound financial policy and good for the country is open to question. It is highly probable, however, that these restructurings are driven more by the fear of these types of takeovers than by straightforward economic forces.

Junk bonds, of course, are not the only source of excessive leverage in recent takeover activity. Large-scale leveraged buyouts and going private transactions have been financed by bank and institutional loans in the tens of billions of dollars as well as by junk bonds. The result is more and more substitution of debt for equity and less and less stable financial structures. In 1984, a year of strong economic growth, the euqity of American corporations shrank by nearly $100 billion. It was turned into debt.

Added to this combination of unequal treatment of shareholders and unsound financial structures is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools, incidentally, are financed by junk bonds. Very large pools of money are in the hands of raiders, similarly financed. This creates a symbiotic set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, and often the reality, of professional traders with inside information, in collaboration with raiders, deliberately driving companies to merge or liquidate. The process is driven by the ability of raiders to make tender offers subject to financing, thereby avoiding costly commitment fees, and getting a free ride if they are bought out with greenmail or the target company is taken over by a white knight. St. Regis Paper, Gulf Oil, and Cities Service were forced to merge as a result of this process.

In summary, what does all this add up to?

(1) At a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading.

(2) At a time when we are trying to strengthen our important industries to make them more competitive, this activity weakens many of our companies by stripping away their equity and replacing it with high-cost debt.

(3) At at time when our financial institutions are under considerable pressure, this activity preempts more and more general credit and causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn.

(4) At a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders. The rights and privileges of shareholders appear to be continually eroded.

(5) Our largest investors, institutions such as pension funds, S&Ls and insurance companies are behaving more and more like short-term traders than like long-term investors.

I believe that these issues are sufficiently serious to warrant the relevant regulatory authorities and the Congress to consider more stringent regulation coupled with new legislation.

These actions should be part of a total package of legislation and/or regulation. They should all be interconnected. It would be unreasonable to remove defensive devices such as poison pills from a company's use unless abusive takeover tactics were limited in a similar vein.

In the area of excessive use of credit, whether junk bonds or otherwise, I believe that regulation as opposed to legislation can handle most of the problems. The SEC and its tender offer rules, the margin rules and the capital requirements set by Federal and State regulators of banks, insurance companies and savings institutions, can deal with most excesses if the reguators decide to act or are directed to do so. This is also true of insider trading and market manipulation by professionals where the SEC has ample authority.

It may be worth exploring some form of taxation on tax-exempt institutions such as pension funds if they engage in short-term trading activities and if their holding periods are below 1 year.

I have made my living for more than 30 years negotiating hundreds of mergers and acquisitions for a variety of corporate clients. Most of these were the result of negotiated agreements; some were bitterly contested, hostile takeovers. I hope to continue this activity for many more years. I believe it to be an integral part of the service an investment banker should provide his clients and that it is an important and constructive factor in maintaining a competitive marketplace. There is no question in my mind that thoughtfully negotiated mergers have a better chance of achieving their objectives than multibillion dollar takeovers, or major restructurings, decided upon over a weekend, as a result of a raid. Nonetheless, there should be room for many types of transactions in our market system, but very clear lines should be drawn between what is acceptable economic and corporate behavior on the one hand, and what is runaway speculation on the other. That is not the case today.

There are always arguments against any changes. Regulation and legislation are inevitably imperfect and may unwittingly restrict perfectly valid activities. However, the itegrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today and regulatory and legislative actions are required to protect them. If this does not occur, the regulatory backlash a few years from now will go far beyond anything that I've discussed here. Thank you. [Applause.]

[The complete presentation of Mr. Rohatyn follows:]

Address by

FELIX G. ROHATYN

Chairman,

MUNICIPAL ASSISTANCE CORPORATION
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Before

THE JOINT ECONOMIC COMMITTEE'S
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A few days ago the Federal Reserve Board adopted a rule to limit the more extreme types of junk bond takeovers by applying the margin rules (i.e. a requirement to put up 50% of the required capital) to a bid by a shell corporation. This rule is largely symbolic since it will affect relatively few takeovers, is easily circumvented and is aimed at the most extreme cases of leverage. The reaction was stupendous. Every agency and department of the Federal government attacked the Fed and Paul Volcker as if they had come out with a plan to nationalize the economy. Editorials screamed in the Wall Steet Journal and many others, summarized by the following excerpt from a full page editorial in the New York Post: "Properly interpreted, then, the effects of this improper new rule will be to curtail the rights of stockholders, to reduce the value of their investment by reducing the number of potential buyers, to encourage foreign ownership of U.S. corporations, to damage the financial services industry, to remove an important incentive for corporations to use their assets efficiently, and to make the economy generally more sluggish.". The only rational interpretation for this dramatic overkill was that our most responsible financial leader, Paul Volcker, was being forced out as Chairman of the Fed in order to promote and protect the most extreme kind of unfettered speculation seen in the Country since 1929. Fortunately for us, Paul Volcker stood firm; how long he can last under these circumstances is an open question. The New Deal is dead; so are the Fair Deal and the Great Society. However, the Casino Society is here and it is here with a vengeance.

I have seen the evolution of mergers and takeovers from the conglomerate merger era of the 1960s, through the growing acceptability of large, "hostile" takeover bids during the 1970s, to the current wave of huge transactions, with offensive and defensive tactics that often go beyond the norms of rational economic behavior. I am not here to argue against the ability of corporations to make acquisitions or to reject being acquired. Takeovers do not have to be friendly; they have to be fair and they have to be soundly financed. Current takeover tactics, both in the legal and financial area, run counter to those principles.

Arguments for new or additional regulation or legislation should be based on national interest issues. The issues involved here are two-fold:

a) The integrity of our securities markets;

b) The safety of our financial institutions;

They are both jeopardized by what is happening today as a result of excesses in connection with takeovers.

These excesses, let me hasten to add, are not limited to the takeover field. They are part of a general pattern of speculation in securities, commodities, currencies, etc. They are part of a trend of excessive risk-taking on the part of financial institutions seeking "performance" at the expense of safety. They are the result of a climate of rapid deregulation with inadequate preparation as to the results in certain areas.

A series of events is eroding the climate of confidence required of our financial institutions. Among these was the financial collapse of several government securities trading firms which led to crisis in the Ohio and Maryland Savings Bank Systems. The financial collapse of the Penn Square Bank which led to the quasi nationalization of the Continental Illinois Bank and the demise of the Seafirst Bank. The repeated credit scares of Third World borrowers. Every one of these events shakes the confidence needed by our financial system. They are, however, only the tip of the iceberg. Our banking system is still exposed to large risks. Many are under the illusion that the Third World Debt problem has been resolved as a result of a series of rollovers; recent events in Argentina, Brazil and Mexico with a combined external deot of $250 billion may create a rude awakening. Elsewhere, if the price of oil were to drop by 20%, not unthinkable under present circumstances, the problems of banks with large energy loans would be compounded by the problems of large oil companies so elegantly restructured as a result of takeover raids and greenmail. To the trillion dollars of Third World bank loans, we have to add the dramatically increased use of debt, both conventional debt and junk bonds, in all types of takeovers and leveraged buyouts and the risk involved if we were to enter a serious recession. One does not have to be Cassandra to be concerned about the safety of our financial institutions and to their vulnerability to sudden jolts.

By the end of 1985, American corporations will owe a total of $1.56 trillion, the highest in our history. After adjusting for inflation, debt has grown a 8.69% per annum in 1984 and 1985 compared with 2.7% from 1975 to 1983. Corporate debt exceeds total net worth by 12%. Total borrowings now represent 81% of the external sources of funds of corporations compared to 56% in 1975. As a result, corporate debt has replaced equity financings with stocks as a percent of external funds declining from 35% during 1975 to 14% currently. American corporations are far more vulnerable coming out of the 1980-1982 recession than they were after the 1974-1975 recession. Since 1982, cost of servicing debt has been absorbing 50% of the entire cash flow of corporations while during the 1976-1979 recovery the cost averaged only 27% of cash flow. The combination of deflation, deregulation and a strong dollar make this a very dangerous equation

In the Securities markets, especially in the takeoverfield, we also find troublesome excesses. Over the long run, the capital markets self-correct, but sometimes abuses become so widespread that the markets must be helped by legislation or regulation. Today that is the case in respect to mergers & takeovers. The abuses fall into several general categories:

a) Unequal treatment of shareholders as part of offensive or defensive corporate actions;

b) Unsound financial structures as a result of excessive leverage;

c) Destabilizing impact of large scale arbitrage and other short-term trading activities as an integral part of mergers and takeovers, and the market volatility created as a result.

I would like to examine each of these briefly.

a) The basic concept of our securities laws, which have been the basis for the world-wide appeal of our Securities markets, has been full disclosure, non manipulation, and equal treatment of all shareholders. The most basic elements of stock ownership, i.e., equal voting rights and equal equity ownership for all common shareholders are now under attack. Both the techniques of current takeovers a well as concurrent court decisions undercut these concepts. For instance, the NYSE is under pressure to permit the listing of common shares with unequal voting rights; and the recent Unocal decision in Delaware permits,in certain cases, unequal payment among common shareholders.

In tender offers, two-tier takeover bids heavily favor professional traders to the detriment of non-professionals. Bids that are made "subject to financing", in many cases directly or indirectly financed by junk bonds, permit the bidder to manipulate the markets without committing himself to purchase. The resulting activity by arbitrageurs and short-term traders create speculative accumulations which, in the parlance of the trade, "put the company into play". Whether the result is "greenmail" or a "white knight" rescue, the result is a large profit for the raider, at minimal risk. The Third-party, or "white knight" takeover, if it occurs, takes place purely to satisfy speculative positions taken as part of the raid.

Because of these tactics, defensive maneuvers have been devised that are equally damaging to shareholders. The payment of "greenmail" is the most obvious and, in many ways, the most old-fashioned of these maneuvers. Selective repurchase of stock, "lock-ups", "crown jewel options", "shark repellent" and "poison pills" of one kind or another, all have been designed to enable managements and boards of directors to interpose themselves between the shareholders and takeover bids. These tactics have been used, sometimes indiscriminately, against bona fide bidders as well as against the more pernicious types. In some of the more extreme cases, i.e., in the defense of Carter-Hawley-Hale in the face of a 100% offer from The Limited and in the defense of Unocal against a partial offer from Mesa Petroleum, the courts permitted the target companies to selectively repurchase their own shares from some, but not all, shareholders. The result, in many cases, is to find companies burdened with excessive debt and their remaining shareholders badly damaged. Phillips Petroleum, Unocal, Carter-Hawley-Hale are all examples of this type of operation.

b) As a result of this activity, financial structures are seriously eroded. I have mentioned above several examples of companies which, in order to remain independent, have depleted their equity and taken on excessive debt. Several of the largest takeovers were brought about as a result of raids, financed by junk bonds, on the target companies which were than acquired by third parties. A large part of the oil industry has been badly damaged as a result. The mergers Chevron-Gulf, Occidental-Cities Service, Mobil-Superior, all occurred as a result of raids or the threat of raids. The deterioration in their combined balance sheets has been dramatic. The premiums received by the acquired shareholders have been paid by the debt of the acquiring companies and, ultimately, by their shareholders. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs. In the meantime, as a result of their high levels of dett, they could be in serious difficulty, in the near term, if the price of oil continues to decline. If one were to write a scenario about how to get the U.S. into trouble as far as energy is concerned, it would be hard to improve on what is happening.

It is in the area of large takeovers that the junk-bond phenomenom is particularly hazardous. High-yield, unrated debt, in reasonable amounts, is a perfectly acceptable financing vehicle for many companies ineligible for investment-grade credit ratings. It is a different story, however, when this type of debt, in the billions of dollars, is used to substitute for equity in the takeovers of very large companies.

The risk in this type of operation is twofold. First, in the actual security of the paper. If the takeover is successful, the servicing of very high levels of debt, at rates of interest in excess of most targets return-on investment, requires significant asset dispositions which may not always be possible or desirable. It is an approach that also completely fails to take into account the fact that a large corporation is an entity with responsibilities to employees, customers and communities, which cannot always be torn apart like an artichoke ~~erector set~~. The alternative to a breakup requires significantly improved operating performance which is very often much easier said than done. Indeed, in looking at many of these raids, one is left to wonder if the intent is really to acquire control or simply manipulate a third-party takeover in order to make a profit with little or no risk.

The second element of risk in this type of paper is liquidity. Much of this paper is privately placed, among a small group of private investors initially, and subsequently to financial institutions such as savings banks, insurance companies and pension funds. Over the last several years, $75 to $100 billion in junk bonds have probably been placed. In many instances, no large scale, liquid public market exists in these securities and purchases and sales are handled through private transactions. Many of the investing institutions are in financial sectors under considerable pressure at this time.

To protect themselves against this type of takeovers, companies have begun large scale restructurings of their own whereby they assume significant amounts of additional debt in order to shrink their equity and increase the price of their common stocks. ARCO and Litton Industries are the most recent example of this trend, the latter shrinking its capital base by more than one third. Whether in the long run, this is sound financial policy and good for the country is open to question. It is highly probable, however, that these restructurings are driven more by the fear of these types of takeovers than by straightforward economic forces.

Junk bonds, of course, are not the only source of excessive leverage in recent takeover activity. Large scale leveraged buyouts and "going private" transactions have been financed by bank and institutional loans in the tens of billions of dollars as well as by junk bonds. The result is more and more substitution of debt for equity and less and less stable financial structures. In 1984, a year of strong economic growth, the equity of American corporations shrank by nearly $100 billion. It was turned into debt.

c) Added to this combination of unequal treatment of shareholders and unsound financial structures is the market speculation which has become an integral part of the process. Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools, incidentally are financed by junk bonds. Very large pools of money are in the hands of raiders, similarly financed. This creates a symbiotic set of relationships which has as its basic purpose the destabilization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, and often the reality, of professional traders with inside information, in collaboration with raiders, deliberately driving companies to merge orliquidate. The process is driven by the ability of raiders to make tender offers "subject to financing", thereby avoiding costly commitment fees, and getting a free ride if they are bought out with "greenmail" or the target company is taken over by a white knight. St. Regis Paper, Gulf Oil, Cities Service were forced for merge as a result of this process.

In summary, what does all this add up to?

1) At a time when we are trying to encourage long-term investment, this activity encourages speculation and short-term trading;

2) At a time when we are trying to strengthen our important industries to make them more competitive, this activity weakens many of our companies by stripping away their equity and replacing it with high-cost debt;

3) At at time when our financial institutions (banks, savings banks, insurance companies) are under considerable pressure, this activity preempts more and more general credit and causes the weakest sectors to acquire large amounts of risky and possibly illiquid paper to show performance. Much of this paper has never been tested in a period of economic downturn.

4) At a time when we need to continue attracting capital from all over the world, our securities markets appear to be more and more under the control of professionals and insiders. The rights and privileges of shareholders appear to be continually eroded.

5) Institutional investors such as pension funds, &L's and insurance companies are behaving more and more like short-term traders than like long-term investors.

I believe that these issues are sufficiently serious to warrant the relevant regulatory authorities and the Congress to consider more stringent regulation coupled with new legislation.

These actions should be part of a total package of legislation and/or regulation. They should all be interconnected. It would be unreasonable to remove defensive devices such as "poison pills" from a company's use unless abusive takeover tactics were limited in a similar vein.

In the area of excessive use of credit, whether junk bonds or otherwise, I believe that regulation as opposed to legislation can handle most of the problems. The SEC and its tender offer rules, the margin rules and the capital requirements set by Federal and State regulators of banks, insurance companies and savings institutions, can deal with most excesses if the regulators decide to act or are directed to do so. This is also true of insider trading and market manipulation by professionals where the SEC has ample authority.

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There are always arguments against any changes. Regulation and legislation are, inevitably, imperfect and may, unwittingly, restrict perfectly valid activities. However, the integrity of our securities markets and the soundness of our financial institutions are vital national assets. They are being eroded today and regulatory and legislative actions are required to protect them. If this does not occur, the regulatory backlash, a few years from now, will go far beyond anything discussed here.

Chairman Obey. Thank you, Felix. We have time for two quick questions.

A Voice From Audience. Mr. Rohatyn, on a slightly different subject but related, could it be fairly said that the prosperity of our economy between 1946 and 1972 was a function of the U.S. victory in World War II and that our financial problems now are a function of not being in that favored position?

Mr. Rohatyn. I'm afraid that that is much too complicated a question for me to answer at this time.

A Voice From Audience. I wondered if—you may have said this publicly but if you have I haven't heard it. Do you think the court award in the Pennzoil-Texaco case of $12 million was excessive?

Mr. Rohatyn. I don't think it's appropriate for me to talk about that. We were the investment bankers for Pennzoil.

A Voice From Audience. I can appreciate your comment about insurance companies and other long-term providers having to keep their assets in long-term financing. But at the same time, if the objective of an organization is to increase the value of the share for its stockholders, how do you refute the argument of trying to keep them from trying to improve the overall value of their stock?

Mr. Rohatyn. Well, I think you've touched on one of the most fundamental public policy issues that has to be discussed in this country in terms of corporate behavior, which is the relationship and the tensions and the balancing between the responsibilities to shareholders, the responsibilities to communities, to employees to maintain competitive enterprises and court decisions are all over the place. There was a decision in Delaware which authorized specifically the directors to take into account not just the responsibilities to its shareholders but community responsibilities and employee responsibilities, and so forth.

There are other decisions that go absolutely the other way. So that all of us operating in the financial area today make it practically a given that you have to put in effect the price that you get, namely, the shareholders' interest absolutely first and paramount.

I think you have to, at least in my view—there is an open question here. First of all, your shareholder today is not what a shareholder used to be 20 years ago. A shareholder by and large today is a short swinger. In many, many cases, the turnover in shareholder profile during one of these takeover changes so dramatically that after 2 weeks you have two-thirds of the company owned by short swing speculators.

So I think sooner or later we are going to have to look into the question: Is it appropriate to get the last dollar out of a takeover to condone breaking up a company, selling it off in pieces, as opposed to doing a straightforward merger between two companies that are appropriately financed where maybe the price might be a dollar or two less but where the long-term future of the enterprise is healthier.

So far, we are operating under the rules that say go for the last dollar, and I question whether in the long run that is in the interest of this country.

Chairman Obey. Thank you very much, Felix. We are going to have to shut this down. We will reconvene back in the original room in the Cannon Building in about 8 minutes.

We have two panels remaining today, the first on productivity that we were talking about this morning, and the second on creating an economic system which reflects American values.

[A brief recess was taken.]

AFTERNOON SESSION

Chairman **OBEY**. I have asked the rest of the members of the Joint Economic Committee to participate as much as their time permits and I would like to ask Congressman Jim Scheuer of New York, who is a member of the Science and Technology Committee, a member of the Energy Committee, a member of the Select Committee on Narcotics, as well as a member of the Joint Economic Committee, to introduce our moderator for the next panel on productivity.

Representative **SCHEUER**. Thank you, Mr. Chairman.

I don't want to press my luck. We have heard a lot of speeches and we haven't even rounded second base and you're going to hear a great many more.

This panel is on productivity, the key to future prosperity, and I think it would be a truism to say that America's prosperity has been based on its productivity over the last century, certainly since World War II. We have taken for granted the fact that we could outplan, outdesign, and outproduce, and outsell any other country in the world. That is one of the underlying assumptions that we have sort of all been weaned on. But it's no longer true.

Many things have combined to reduce our productivity in the last four decades and we have found that we aren't automatically preeminent, that we're going to have to fight tooth and claw to catch up. We are in a catch-up ballgame at this point in time and we should be feeling a desperate sense of urgency in catching up in terms of productivity with the Japanese, the West Germans, the Swedes and other countries who have exceeded us and who don't carry some of the burdens that we carry.

For example, the awesome burden of adult illiteracy which one of the panelists said this morning was 7 or 8 percent of our whole work force compared to a half of one percent of the Japanese.

Our poor record in productivity, along with other things, is a major factor in our discompetitive, uncompetitive posture today. We are really not effective players in global commerce and if we want to be effective players in global commerce and arrest the decline in American profits and living standards and wages, we are going to have to make fundamental structural changes in our economy.

We must accelerate the growth rates in productivity if we are to sustain our standard of living and arrest our increasingly uncompetitive posture, where we're competing not only with high-wage countries in Western Europe and Japan but low-wage countries in Asia and elsewhere where wages are frequently as little as 10 percent of ours.

Meeting this challenge will require broad changes in the private sector, in labor-management relations, in better targeted and more flexible public policies, and in a willingness in all sectors of the economy—of consumers, of investors, of Government, of labor-management relations, and of labor itself—to accept short-term belt-tightening in order to regain our position at least as a competitive equal. Otherwise, if we are unwilling to make those short-term sacrifices, we're going to find that we are trending toward a long-term decline in productivity and living standards which will follow the painful and sad pace of decline that England has followed in the last three-quarters of a century.

The moderator of our panel this afternoon is a friend of I guess most of us in this room. For many years he covered the economic beat in Washington for the New York Times with very great distinction. He now serves as Assistant Director of Public Affairs for the Office of Management and Budget. It's a pleasure to introduce Ed Dale.

He has also served the Joint Economic Committee in a meaningful way at Dick Bolling's urgings when he contributed to the JEC's special study on economic change in the 1979-1980 era. Now, it's a pleasure to introduce Ed Dale.

PANEL: PRODUCTIVITY: THE KEY TO FUTURE PROSPERITY—ED DALE, MODERATOR

Mr. DALE. Well, I guess most of my colleagues as moderators of these panels are still working journalists and I'm an exception to that. I was a newspaperman here for just under 100 years, but I have now completed 4½ most stimulating years with Dave Stockman. Of course, it's had its ups and downs. After that episode of the article in the Atlantic Monthly, there was a time there when I was in the unique position of being under a Trojan horse when it was trickling down. [Laughter.]

As we approach the elusive subject of productivity, I hope you will permit me to repeat for you a gentle spoof of economists and of standard economic wisdon that I've been using lately, more in connection with the thing I deal with now, the budget rather than productivity.

I imagine myself back in 1975, 10 years ago, and I've been endowed with an unusual special insight into the future, but it's only a kind of partial crystal ball. It can tell me with great precision what the Federal budget outcome will be in any year in the future but it can't tell my any other economic variable.

So armed with my partial knowledge of the future, I poll a group of economists and other intelligent people back in 1975 and I tell them that I know for a fact that in 1986 the Federal budget will have a deficit exceeding $200 billion for the fourth consecutive year, more than 5 percent of the GNP.

This news will shock them, of course, and in fact they won't even believe it. But I assure them that it's true and then I ask them one question: What would be the U.S. inflation rate under those conditions in 1986?

Well, I'm sure everyone in this room can readily imagine the answers that I would get; that is, that U.S. inflation would surely be 20 percent or more. And yet here we are with inflation at around 3.5 percent, the lowest by some measures since the 1960's. In low moments over there in OMB I sometimes think, gee, if I can only get the deficit to $300 billion, inflation would disappear altogether. [Laughter.]

Well, I cite this imaginary episode just to remind us, if we need reminding, that all of these matters require a little humility. Productivity and its analysis is a good case in point, but there are a few things I think that we can not only agree upon but which are indeed truths, not theories or deductions but facts.

First, the improvement in productivity, the output for each hour worked, is essentially the source of any improvement in the standard of living, the increase in real income per capita over any sustained period of time.

In fact, productivity is the quintessential "Mom's Apple Pie." Everybody is for it and nobody is against it. And, second, productivity performance of the American economy has gone through several stages in the past 40 years since World War II, brilliant up to the late 1960's, gradually worsening until about 1973, dismal from 1973 to 1981, and a modest improvement since 1981.

What our budget will say in its section on the economic assumptions is that from the cyclical peak—that is, the third quarter of 1981—through the fourth quarter of 1985, output per hour worked in the private nonfarm business sector has been up about 1.5 percent annual rate. That covers the period of both the severe recession of 1982 and the 3 years of recovery since.

Well, this is a little closer to normal productivity growth but still nothing spectacular, and we're assuming about 2 percent from now on.

Well, those are the facts and where we go from here is the subject of our panel today, and we will start with one of the best known productivity experts in the country, John Kendrick, Professor of Economics at George Washington University, and a foremost expert on productivity and its determinants.

PRESENTATION OF JOHN W. KENDRICK

Mr. **Kendrick**. Thank you, Mr. Chairman.

I might mention that in order to be here with my distinguished colleagues today I had to fly back from Central America where I was consulting with a U.S. A.I.D. mission. A.I.D. has made a concessional loan to the government of this country with certain conditions and two of the more important conditions were that that country reduce its overall budget deficit significantly and, second, that it increase its development capital outlay.

And when my A.I.D. mission colleague there found I was flying back here to give advice to Congress, he said, "Be sure to give them the same advice that we're giving Belize." When I come in a few minutes to six or eight policy recommendations, these two are certainly going to be in it.

Our chairman has already reviewed the record of productivity growth over the past 40 years. In my written paper which I think is available—50 copies, which is not enough for everyone—but later when you see it you will see I have a table there for the various periods which he demarcated for us of changes in real gross product, productivity, and also the sources of growth in productivity using a growth accounting model of the sort pioneered by Edward

Denison. This seeks to explain why we had good growth for the first quarter century after World War II, why we had the slowdown, and why we have had a partial recovery from 1981 to 1985. I have projections for the year 2000 as to what I think we could do, and I think that we could get back on our long run growth path of, say, 2.5 percent average annual increase in real product per labor hour which together with a little over 1 percent growth in labor input means that we could have overall economic growth between 3.5 and 4 percent again for the rest of this century. That would mean a 50-percent increase in real income per capita and that's certainly worth striving for.

There's no time for me to go into my quantification of the relative importance of the different factors causing good performance and then the slowdown in performance. Just let me say that they relate to half a dozen major factors most economists agree on as being important causes of productivity advance. We all give somewhat different weights to these different factors, but in effect the most important causal forces behind changes in output per hour are changes in capital formation and, thus, tangible capital goods per worker, to technological progress particularly of the cost-reducing variety, through innovation in the ways and means of production, through human investments, through changes in the composition of the labor force over which we don't have much control, also through changes in the quality of land and natural resources again through which we don't have much control, through changes in the composition of outputs which we don't have much control over in a free market economy; but then through changes in volume of production which give us economies of scale or economies of utilization. And here, of course, is where we get into one of the major responsibilities of the Council and the Joint Economic Committee to recommend policies for reasonably stable economic growth. And finally, there's the whole area of labor efficiency, labor management relations, and so forth.

Well, we have had some improvement since 1981 or so, partly because, as Herbert Stein said this morning, no unfavorable trend goes on forever. There are certain socioeconomic mechanisms that try to put a society or economy back on the path if it's realizing unfavorable development.

In 1979, the Joint Economic Committee issued a unanimous report—I quoted it in my paper—recommending measures to stimulate private investment and to stimulate productivity growth in the economy. Already in the late 1970's capital gains taxes were reduced. There were some favorable tax changes, but it remained for the Economic Recovery Tax Act of 1981 as modified by TEFRA in 1982 to really give us some major tax reduction, including the accelerated cost recovery system which gave a great boost to investment.

As a result, investment did better than usual during the recession of 1982. Productivity actually didn't drop in 1982, as it often does in recessions, and we had 2 very good years of better than 3 percent in 1983 and 1984. In 1985, productivity growth was down, of course, because of the very sharp deceleration in the growth of real product, particularly early in 1985, which is a cyclical type impact on productivity.

But as my table shows, we were up between 1.5 and 2 percent from 1981, the peak year, to 1985, which had a similar rate of unemployment. So I think Lester Thurow was a little too jaundiced in interpreting our record. We are on our way back to good recovery, to get back to the trend rate of maybe 2.5 percent which I think we can be on for the rest of the century if we do the right things.

Now, unfortunately, we haven't gotten back there quite yet because of certain factors which I want to mention in the process of giving six or eight policy recommendations.

First of all, I think we must work for lower real interest rates. The program has a chart showing real interest rates and if you look at the chart behind the schedule of events you will see they are still quite high, which discourages investment, and it's particularly important that these come down because the initial stimulus of tax changes have pretty well worn off and due to business expectations of unfavorable tax action the plans for investment are pretty level this year.

The main things, of course, are reducing the deficit, even if a tax increase is necessary, although I hope it would be a consumption type tax; and second, a continued accommodative monetary policy. And real interest rates have resumed a downward trend in recent months due to favorable expectations on both fronts due to congressional actions and also due to Volcker's statement in October with respect to accommodative monetary policy since there was no evidence of imminent inflation.

Next I think we have to mitigate the unfavorable treatment of business. In the House tax bill rates were lowered by shifting considerably higher taxes to business and that's one reason why the outlook for this year is not so good on investment. However, a combination of further cuts in taxes plus some mitigation of that unfavorable tax treatment will help. I personally favor a consumed income-type tax but that isn't in the cards right now.

Next, I think we have to continue to push for a lower value of the dollar. Lower interest rates will help. And the action of the Group of Five is helping, and that will increase our trade balance and thus increase GNP growth with the favorable economies of scale.

We need to further reduce economic regulations and rationalize social regulations. We also need to continue to promote favorable labor-business relationships, which the Department of Labor and the Federal Mediation and Conciliation Service are working on. I'm sure we will hear more of that from Ray Marshall and others. I think we have made progress with productivity promotion programs both with and without financial incentives.

Finally, Mr. Chairman, I think that we need a focal point in the Federal Government where economic growth analysis is carried on, longer-run projections are made, and policy options are developed for consideration by the Congress. In my paper I appended a set of 99 specific recommendations for productivity growth I had made several years ago, some of which have been enacted, but we need a focal point.

The Council and the Joint Economic Committee I think are more focused on short-run development, putting out fires, immediate measures for the next year or so. I think it would be important, not to have a productivity center. We have the American Productivity Center with Jack Grayson here from Houston, and 50 other private centers. I don't think we need that in Government. But I do think we need some group that will focus on the kinds of policies such as I have mentioned to put us back on the productivity growth path.

Thank you.

[The complete presentation of Mr. Kendrick follows:]

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THE AMERICAN ECONOMY IN TRANSITION:
FROM THE SECOND WORLD WAR TO THE 21st CENTURY

PRODUCTIVITY: THE KEY TO FUTURE PROSPERITY

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In this paper I shall first review the U. S. productivity and economic growth record of the past forty years. This will include brief explainations for the relatively strong performance for the first two decades, and then for the subsequent deceleration. The recovery since the 1981-82 recession suggests that the economy is returning to a stronger trend-rate of increase in real gross product and productivity. But I shall note several additional policy measures beyond those already taken that will be needed to ensure that the relatively optimistic scenario I project for the rest of the 20th Century can indeed be realized.

Review of Productivity Developments Since 1948

Productivity trends since 1948 may be summarized briefly with reference to Table I. That table uses a "growth accounting" format similar to that pioneered by Edward F. Denison.[1] It presents a decomposition of the average annual rates of growth in real gross product of the U. S. business economy (more than

80% of total GNP) in terms of the growth of factor inputs (labor and capital including land) and the growth of the labor productivity and total factor productivity ratios. It then estimates the percentage point contributions of the major causal factors to the percentage rates of growth of productivity. Some of the latter estimates are quite firmly based while others are basically informed judgments, but I believe the numbers give a good idea of the general orders of magnitude of the various components of growth. Growth accounting also provides a systematic framework for projections, also included in the table for the year 2000, and for the development of policy options discussed in the last section of this paper.

Between the period 1929-48, dominated by the great depression and World War II, and the ~~subsequent~~ "golden era" of American economic growth over the subsequent quarter century 1948-73, the growth of real gross product accelerated strongly. It rose from about 2½ percent a year, on average, to the better than 3½ percent rate that had prevailed for more than a century prior to 1929. Total factor productivity grew at about the 2 percent trend rate that had prevailed since World War I. But labor productivity growth accelerated to ~~around~~ 3 percent, reflecting strong increases in real capital per worker, and an associated acceleration in technological progress.

There was some deceleration in productivity growth in the latter 1960s, associated with accelerating inflation during the VietNam conflict. But the major slowdown in productivity growth began in 1973. Between the 1948-73 and 1973-81 periods the growth rate of real product slowed from ~~3.7~~ to 2.2 percent, on average. The average annual rate of growth of real product per labor hour decelerated from 3 percent to ~~less than~~ one percent, while the growth of total factor productivity virtually ceased after 1973 due to declines in capital productivity.

The productivity slowdown was triggered in the first instance by the quadrupling of oil prices by OPEC in 1973, followed by a doubling in 1979. The initial oil shock was aggravated in 1974 by the food and farm price explosion. These events led to an accelerating wage-price spiral which eroded economic profits and reduced the growth of real capital per worker between 1973 and 1981. There was also a decline in the ratio of R&D to GNP from a peak of almost 3 percent in the mid-1960s to 2.2 percent in the latter 1970s, which suggests a slowing in the rate of cost-reducing technological innovations.

In addition to these depressants on the growth rate from 1973 to 1981, there were a number of other factors as indicated in Table I.

The quality of land and natural resource changes in reserves deteriorated somewhat. Output mix through resource reallocations became less favorable as the movement out of agriculture was largely completed. The average experience of the workforce continued to decline as the percentages of young workers and females rose. The costs of compliance with government regulations increased relative to GNP. Changes in the volume of production were particularly unfavorable after 1973. Specifically, economies of scale fell as the growth rate decelerated between 1973 and 1981, and as the rates of utilization of both plant and the labor force fell well below the most efficient rates.

Students of the productivity slowdown differ somewhat on the relative importance of the various factors. But the ones mentioned here and shown in the table are generally those identified as being important.

Since the last business cycle peak in 1981, productivity appears to be moving back towards a stronger trend-rate. Despite the 1981-82 economic contraction, real product per labor hour fell ~~managed a fractional gain.~~ ~~This contrasts with the decline in~~ the 1974 recession, and ~~again~~ in 1979-80. During the subsequent recovery, between 1982 and 1985, real gross business product per hour grew by ~~better than~~ 2½ percent a year on average--~~around 3 percent the first two years~~ but ~~less~~ in 1985 as the recovery slowed down. This was a ~~bit~~ under the average increase of 3.2 percent during the first three years of previous recoveries. But it suggests that productivity growth was returning to a more normal trend rate than the 0.6 percent average between 1973 and 1981. Indeed, the average increase between the peak year 1981 and 1985, which had similar rates of unemployment, was ~~close to 2~~ percent. ~~This was about half the rate of gain of real~~ gross product, ~~close to the previous relationship between productivity and output changes.~~

The better productivity performance since 1981 is due to a reversal of most of the negative forces at work during the previous decade. Specifically, capital formation and the rate of substitution of capital for labor were stronger due importantly to the net effect of the Tax Acts of 1981 and 1982. The rate of technological progress was higher reflecting strong increases in real research and development outlays since 1978. Changes in the age-sex composition of the work force shifted from a negative to a positive influence as the average age and experience of workers began to rise. Economies of scale increased with stronger growth of real GNP. Rates of utilization of industrial capacity were a bit higher in 1985 than in 1981, and the unemployment rate fractionally lower. Regulatory "drag" was somewhat less than in the 1970s. Also there is evidence that labor efficiency as such was higher, as many firms instituted productivity improvement programs to help improve their competitiveness in domestic and foreign markets. There is some time-lag before most of these developments take effect, however.

Policy Issues

The groundwork for stronger growth of real product and productivity in the 1980s was already laid in the late 1970s when it was becoming clear that the slowdown of productivity growth and acceleration of inflation required countermeasures. The unanimous report of the Joint Economic Committee in 1979 called for "... the adoption of longer-run policies aimed at expanding the nation's productive potential in a manner than raises dramatically the growth of American productivity."[2]

Capital gains tax rates had been cut substantially in 1978, and the Revenue Act of 1978, which took effect in 1979, contained several provisions designed to increase saving and investment. Even more important, in the fall of 1979 the Federal Reserve Board shifted its major target to controlling the growth of the money supply at rates that dramatically reduced inflation by 1982, setting the stage for recovery.

Major fiscal stimulus was applied by the Economic Recovery Tax Act of 1981 as modified and supplemented by the Tax Act of 1982. The substantial cuts in income tax rates and the accelerated cost reduction system are estimated to have reduced the marginal business tax rate on income from new investment by approximately one-half.[3] This, together with disinflation and rising research and development outlays (R&D), contributed importantly to the strength of business investment from 1982 through 1985. The enactment of the 25 percent incremental R&D tax credit in 1981 augmented the growth of private R&D expenditures. The strong upward trend of public R&D outlays since 1976 likewise benefitted the business economy. Total real R&D spending is projected by the National Science Foundation to increase by better than 7 percent in 1986. The climate for private investment has also been improved by the efforts in recent years to reduce and rationalize Federal Government regulations.

It is my view that the increase of productivity was ~~a bit~~ [illegible] less in relation to output growth than in previous recoveries because of several remaining negative influences. One has been the high real interest rates which have meant less private capital formation than would otherwise have taken place. Although rates have declined substantially from their peaks, they remain high, particularly on the long end of financial markets, by historical standards. This has been due to the persistence of inflationary expectations, fed by the huge Federal Government deficits.

Recently real interest rates have been declining again as the Federal Reserve Board has pursued an accomodative monetary policy in view of slow economic growth and continued slack in the economy, and asthe Administration and Congress have expressed a firm resolve to reduce the deficit in this and future fiscal years. It is important that Congress implement this resolve, even if it means an increase of tax rates (preferably on consumption) in order to protect national security and essential social programs.

A second factor has to do with tax policy. Just as ERTA gave a boost to business investment, so the Congressional discussions and actions in 1985 dampened growth of plant and equipment outlays and caused a levelling out of planned outlays in 1986.

The lowering of personal income tax-rates through base-broadening is a good idea. But to the extent that it substantially shifts the tax burden to business and reduces expected rates of return on investment, it must affect new investment adversely. When the current House tax bill comes before ~~the Senate and~~ [illegible] a conference committee, I hope that the increased tax burden on business will be reduced. My own preference, and that of many economists, would be to shift generally from income taxes to consumption-based taxes in order to mitigate or eliminate the double taxation of saving. This would help reduce interest rates further, and directly stimulate new investment by increasing after-tax rates of return. Indexing of interest income, depreciation allowances, and asset values in estimating capital gains for tax purposes would also help stimulate capital formation and thus productivity growth.

A third impediment to the recovery of productivity until recently has been the overvalued dollar in foreign exchange. This has impeded the recovery of export-oriented industries. Since these are generally high productivity growth industries, their relative decline has reduced the average productivity growth rate. Since February 1985, however, the downward trend of interest rates and the actions of the Group of Five have resulted in substantial declines in the value of the dollar. If those declines hold and are extended somewhat further, I believe that significant reductions in the trade deficit this year and beyond will help bolster the expansion of real product and productivity.

With respect to non-tangible investments, I believe that continued tax incentives for R&D are warranted in view of its externalities and seminal contributions to advances in technology and productivity. Federal funding of R&D, particularly in civilian production, should continue to increase at least in line with the 3 to 4 percent secular growth of real GNP. Likewise, public and private outlays for education, training, health, safety and mobility should also be encouraged to grow, since rising human investments per member of the labor force have been an important source of productivity advance.

Further cut-backs of economic regulations where warranted and continuing rationalization of social regulations can continue to slow the growth of complexity and costs of compliance. It is also important that the Department of Labor and the Federal Mediation and Conciliation Service continue to promote the improvement in the relationship between business and labor, both organized and unorganized, which has taken place in recent years. There has been a widespread expansion of joint labor-management productivity teams, quality circles, productivity gainsharing, and other employee involvement programs, both with and without financial incentives, that are credited with contributing to the recovery in productivity growth.

Finally, it is crucial that the Federal Government pursue the basic goals of the Employment Act of 1946 as effectively as possible. Avoidance of severe economic contractions and pro-growth policies without accelerating price inflation will enhance capital formation, economies of scale, and productivity growth generally. But excessive stimulation that would drive unemployment below its natural rate would be counter-productive.[5]

Although the Congress may have been well advised not to extend the life of the National Center for Productivity and Quality of Working Life in 1978, there is the need for a focal point in the Federal Government to coordinate and assemble economic growth analyses, projections, and policy options for promoting the long-term growth of output and productivity. That point should probably be in the Council of Economic Advisers which has hitherto been predominantly involved with current economic analysis, forecasts, and development of near-term policy proposals.

Appended to this paper is a list of ninety-nine specific policy options for promoting productivity growth which I prepared in 1980. They are organized according to the headings of the growth accounting table. Some have since been enacted or ordered, but many of the others are worth consideration. They are discussed further in the paper from which they were abstracted.[6]

If we, as a nation, continue to pursue pro-growth policies of the type discussed here, I see no reason why we cannot enjoy at least as strong an average productivity growth rate as has prevailed for the past forty years. That is the judgment that emerges from my economic projection shown in the last column of Table 1 and explained in the article from which it was drawn.[7] The 2½ percent a year average annual rate of growth in labor productivity would mean an increase in real income per capita of around 50 percent by the beginning of the 21st Century. That is a goal worth striving for.

Table I.

Sources of Growth in Real Gross Product: U. S. Private Business Economy: Selected Periods 1948-85 and Projections 1985-2000.

	Actual			Projected
	1948-73 [3]	1973-81 [3]	1981-85 [p]	1985-2000
	(Average annual percentage growth rates)			
Real gross product	~~3.7~~ [illegible]	~~2.2~~ [illegible]	~~2.4~~ [illegible]	~~3.8~~ [illegible]
Total factor input	1.7	2.0	~~2.0~~ [illegible]	~~2.0~~ 1.4
Labor	0.7	1.4	1.6 [illegible]	1.1
Capital	3.6	3.2	2.7	~~3.6~~ [illegible]
Real product per unit of labor	~~3.0~~ [illegible]	~~0.8~~ [illegible]	1.7 [illegible]	2.9 [illegible]
Capital/labor substitution	1.0	0.6	~~0.4~~ [illegible]	0.8
Total factor productivity	~~2.0~~ [illegible]	~~0.1~~ [illegible]	~~1.3~~ [illegible]	~~1.6~~ [illegible]
	(Percentage point contributions to growth)			
Advances in knowledge	1.4	0.7	1.0	1.0
Changes in labor quality	0.5	0.6	0.9	0.9
Education and training	0.6	0.7	0.7	0.6
Health and safety	0.1	0.1	0.1	0.1
Age-sex composition	-0.2	-0.2	0.1	0.2
Changes in quality of land	0	-0.2	-0.2	-0.3
Resource reallocations	0.4	0.1	0	0
Volume changes	0.3	-0.3	0.3	0.5
Economies of scale	0.4	0.2	0.3	0.3
Capacity utilization	-0.1	-0.5	0	0.2
Government regulations	0	-0.2	-0.1	0
Actual/potential efficiency and n.e.c.	[illegible] ~~-0.0~~	-[illegible] ~~-0.0~~	-[illegible] ~~-0.0~~	[illegible] -0.3

p = preliminary

Note: The estimates 1948-85 are ~~will be revised prior to publication,~~ based on the recently revised estimates of real gross national product, ~~including final numbers for 1985~~ [illegible]

John W. Kendrick

FOOTNOTES

[1] Edward F. Denison's most recent work is Trends in American Economic Growth, 1929-1982 (Washington: The Brookings Institution, 1985).

[2] U. S. Congress, Joint Economic Committee Midyear Report and staff study, Outlook 1980s (August 1979), p. 6.

[3] See Charles R. Hulten and James W. Robertson, "Corporate Tax Policy and Economic Growth: An Analysis of the 1981 and 1982 Tax Acts," Working Paper (Washington: The Urban Institute, 1982).

[4] National Science Foundation, Science Resource Studies Highlights, January 1986.

[5] John W. Kendrick, "Cost Containment Prolongs the Expansion," AEI Economist, May 1985, pp. 1-8.

[6] John W. Kendrick, "Policies to Promote Productivity Growth," in Agenda for Business and Higher Education (Washington: American Council on Education, 1980).

[7] John W. Kendrick, "Long-Term Economic Projection--Stronger U. S. Growth Ahead," Southern Economic Journal, April 1984.

(ACE-1980).

Summary of Proposed Policy Options

Note: This outline should be used in conjunction with the discussions in the paper, which provide background and fuller explanations. Page references to the text are given after each major subheading.

Stimulating business investment and saving (p. 54)

Improving the investment climate (p. 56)

1. Measures to enhance business confidence:
   a. Promote productivity growth by combination of policies recommended in this paper, thus contributing to reduced inflation
   b. Reduce instability of economic growth
   c. Rationalize government regulations and other intervention in economy

Increasing returns on investments (p. 57)

2. Restore adequate profit margins after adjustment for inflation
3. Reduce average unit cost increases relative to average price increases
4. Reduce average effective tax-rate on corporate profits by one or more of the following measures:
   a. Increase depreciation allowances
      1) Shorten lives of assets in computing tax-depreciation (as in 10-5-3 Jones-Conable bill formula)
      2) Index depreciation to replacement cost
   b. Increase the investment tax credit and expand its coverage to new construction
   c. Reduce the corporate income tax rate
   d. Reduce or eliminate the double taxation of dividends by partial or complete deductibility of dividends from the corporate profits tax base
   e. Give further study to integration of the personal and corporate income taxes
5. Reduce personal income tax rate
   a. Reduce rates on all brackets, and/or index the brackets
   b. Reduce the 70 percent tax marginal rate on "unearned," property income to the 50 percent tax rate that applies to labor income

Reducing the explicit or implicit cost of financing new investment (p. 61)

6. Measures to raise equity prices and reduce the cost of equity financing

7. More favorable tax treatment of capital gains
    a. "Rollover" provision to exempt capital gains that are reinvested
    b. Reduce or eliminate capital gains tax
    c. Tax only the part of capital gains which exceeds the increase in the CPI over the holding period
    d. Liberalize loss deduction provisions
8. Reduce the double taxation of dividends by increasing the $100 dividend exclusion, or by partial credits against dividends received
9. Reduce the real interest rate by encouraging saving by measures in addition to recommendations 2–5.
10. Eliminate Regulation Q
11. Reduce the rate of taxation on interest by exempting some amount or proportion, or taxing only *real* interest receipts
12. Expand savings plans, such as IRA and Keogh, on which taxes are deferred; and expand tax exemption or deferral on income from property, e.g., dividend reinvestment
13. Plan governmental budget surpluses at high employment by curbing expenditure increases

Value-added tax (p. 64)

14. Consider and study value-added tax as means of recouping initial tax losses from income tax reductions

Accelerating relative productivity growth and relative price reductions in capital goods industries (p. 65)

15. A higher investment tax credit for capital goods manufacturers than for other firms
16. Priority for these producers in other applicable measures to promote cost-reducing innovations

Promoting advances in technological knowledge and innovation (p. 66)

Policies to increase R&D activities (p. 66)

17. Federal funding of basic and applied R&D should be gradually and predictably increased in real terms
18. Expand the present investment tax credit to cover business-financed R&D, (or)
19. Grant a larger tax credit on annual increments in R&D outlays
20. Expand the present tax credit to include laboratory construction, and consider expensing both lab equipment and plant for tax purposes, in lieu of investment tax credits for business
21. Grant R&D subsidies of 10 percent for firms with no net income, and consider subsidies as a substitute for the tax credit generally

22. Establish a federal government organization to support cooperative business-university R&D projects, along the lines of S. 1250

Revising the patent system to promote invention and innovation (p. 69)

23. Lengthen the period of patent protection
    a. Increase from 17 to 20 years, or
    b. Extend to compensate for delays in commercialization due to regulations
24. Transfer patent rights made under government contract or funding to firms or individuals responsible
25. Improve the reliability of the patent grant:
    a. Strengthen the Patent and Trademark Office to provide modern search tools and rigorous examinations of applications
    b. Provide a reexamination process
    c. Provide a central court to hear patent appeals
26. Require federal courts to conduct patent litigations with express concern for time and expense
27. The statutory standard of patentability should be clarified
28. Encourage other countries to provide U.S. inventors the right to obtain enforceable patents

Expanding the dissemination of scientific and technological information (p. 71)

29. The Patent and Trademark Office should strengthen its information gathering, retrieval, and dissemination functions
30. The Worldwide Information and Trade System in the Commerce Department should be strengthened, and collect information about foreign regulations, standards, and requirements for product approval
31. The federal government should augment its efforts to increase international technology transfer by further negotiations
32. The informational program of the Office of Technology Assessment and Forecast of the PTO should be expanded with respect to foreign technologies
33. More technical information should be made available by federal agencies

Using procurement policies to promote innovation (p. 73)

34. The Office of Federal Procurement Policy (OFP) should issue and execute a policy statement that establishes goals and methods for stimulating innovation
35. Contracting personnel in GSA should be made more aware of technological developments in their fields
36. The OFP should share its developing expertise on use of procurement policy to stimulate product and cost-reducing innovations by sup-

pliers with state and local governments, including school systems and universities

Promoting small technology-based enterprises (p. 75)

37. Allow more favorable stock-options for founders and key personnel
38. Allow tax-free rollover of equity investments, and the flow-through to investors of start-up losses
39. Simplify SEC Rule 146 and liberalize Regulation A limits
40. Aid by procurement policy and assistance with regulatory compliance
41. Expand SBA direct loans and its financial assistance to small business investment companies

Increasing the quality of labor (p. 76)

Policies to promote the quantity and quality of education and training per worker (p. 76)

42. The National Institute of Education should expand its support for research on and development of new and improved educational methods and technologies
43. The NIE should promote the diffusion of new, tested technologies, encouraging centralized purchasing consortia
44. Colleges and universities should require courses in education, including usage of modern technologies, or prospective and current faculty members
45. Increase funding of federal student aid programs, and relax aid requirements in some instances
46. Institute tax credits for some portion of tuition payments
47. Expand funding or government guarantees of student loans
48. Place greater emphasis on aptitude and interest testing and career counseling
49. Expand continuing adult education programs, including the "open university"
50. The NSF should steadily increase research grants to higher education institutions
51. The federal government should provide tax credits or matching grants for business or individual contributions for basic and applied research at public and private nonprofit institutions
52. Expand and strengthen formal and on-the-job training programs authorized under CETA
53. The value of in-house training must remain exempt from income taxes
54. Expand "executive-in-residence" programs of higher education institutions, and utilize executives to improve nonteaching technologies and methods
55. Expand "scholar-in-residence" programs of companies

Enhancing health and safety (p. 82)

56. Expand federal funds for medical research, and improve the allocational balance in relation to requirements
57. Relax testing requirements of the 1962 Amendments to the Pure Food and Drug Act
58. Accelerate programs of preventive medicine and dissemination of health information, with particular emphasis on the schools
59. Further restrict advertising of harmful substances, and step-up counter-advertising
60. Liberalize deductions for health care in the individual income tax
61. The Department of HEW should devote more resources to measurement and analysis of productivity in hospitals and other health facilities, developing new technologies, and promoting diffusion of best practices

Changes in labor force mix (p. 83)

62. Mandatory retirement age requirements should be abolished, and incentives for early retirement under Social Security and private pension plans reduced

Offsets to the declining quality of domestic natural resources (p. 85)

63. Rely primarily on market pricing to promote exploration, conservation, and development of substitutes
64. Liberalize international trade and investment flows, buttressed by diplomatic measures to ensure access and to combat cartel pricing
65. Improve long-term demand and supply projections to help anticipate market signals
66. Continue federal funding of research into new sources and new technologies

Facilitating reallocations of labor and capital (p. 86)

67. The antitrust laws must continue to be enforced vigorously, but with due consideration of impacts on innovation
    a. Antitrust laws should not be interpreted to conflict with the patent regime
    b. Joint R&D ventures should be permitted
    c. In reviewing proposed mergers, weight should be given to innovational effects
68. In considering proposed legislation to break up certain classes of firms, Congress should consider the effect on innovational activity as well as on markets
69. Increased market shares resulting from the introduction of new technology should not ordinarily lead to antitrust suits

70. Acquisition of small technology-based firms by larger firms should generally be permitted
71. Economic regulations should accord a larger role to market forces, as in the airline industry, and entry controls should be eliminated
72. Public utility commissions should use the rate-setting power more fully to promote productivity growth
73. Unreasonable restrictions on entry by some labor unions and professional associations should be abolished
74. CETA programs to retrain, place, and relocate displaced workers should be expanded and made more effective
75. Government intervention to support declining firms and industries should be replaced by more assistance for the transfer of resources to expanding sectors, as under the Economic Development Act
76. Expand and improve the federal statistical system to provide more timely data, analysis, and projections
77. Wage and price controls should be instituted only as a last resort to break an inflationary spiral, and then only on a temporary basis

Volume factors (p. 89)

78. The staff of the Council of Economic Advisers should be expanded to enable it to perform more adequately the function of medium- and long-term projects and policy formulation to achieve stronger rates of economic growth
79. The Economic Policy Group and the Congress must take the necessary measures to mitigate economic contractions generally, and to prevent the current slow-down from reaching the proportions of the 1973–75 contraction

Increasing the net contribution of government (p. 92)

Improving productivity-enhancing services and activities (p. 93)

80. The President should create a National Productivity Office to provide leadership and coordination of federal programs to promote productivity
81. The Bureau of Labor Statistics should expand its productivity statistics and analysis program
82. Expand the Joint Financial Management Improvement Program for analyzing federal government productivity performance and making and following-up on recommendations for improving productivity of the agencies
83. The Intergovernmental Personnel Program of the Office of Personnel Management should be given the necessary funding to assist state and local government management improvement and innovation efforts

Reducing the negative impacts of government interventions (p. 96)

84. The Administration must implement more fully Executive Order 12044 which directs reforms of the regulatory system
85. Congress should broaden the mandates of regulatory agencies, requiring them to consider the undesirable side-effects of regulatory actions, particularly as they inhibit and delay innovation
86. Use economic incentives (e.g., effluent taxes) to accomplish regulatory goals
87. The uncertainties of regulation should be decreased, and consistency increased:
    a. Issue statements of long-range regulatory objectives and intent to serve as guidelines, and consult with regulated parties prior to changes in regulations
    b. Establish interagency coordinating committees to ensure consistency of regulations
88. Regulate standards of performance rather than technology and processes
89. Regulatory agencies should take account of impacts of their actions on U.S. competitiveness in world trade
90. Procedures and paperwork should be simplified for smaller companies
91. Product liability laws should be reformed
92. Regulations should be confined within the bounds of existing knowledge, and the relevant knowledge-base expanded
93. The recommendations of the Commission on Federal Paperwork should be further implemented to reduce the paperwork burden

Improving labor efficiency and other factors (p. 99)

Increasing the ratio of actual to potential labor efficiency (p. 99)

94. The Department of Labor, in cooperation with private productivity centers, should encourage and assist firms to establish joint labor-management productivity teams or other types of productivity improvement programs
95. The Office of Personnel Management should promote the establishment of productivity committees in federal agencies, and assist this activity in state and local governments
96. Pay and promotion in government agencies should be more closely tied to performance
97. Restrictive work rules should be moderated or eliminated

Other causal factors (p. 101)

98. The National Institute of Education should encourage school systems and higher education institutions to install, expand, and improve instruction and courses in values and ethics

AGENDA FOR BUSINESS AND HIGHER EDUCATION

99. Expand the scope and quality of economic education in the schools, colleges, and in the broader community

Addendum A

PRODUCTIVITY POLICY INTERESTS OF BUSINESS AND HIGHER EDUCATION

Although this paper does not address specific policy measures that business and academic leaders could pursue, there are many areas of common interest. For example, tax measures to stimulate private investment are obviously of chiefly academic interest to representatives of public and private nonprofit educational institutions, although we would support the creation of a favorable investment climate as a precondition for a healthy growing economy that benefits all sectors. But both business and education have an immediate interest in measures to increase R&D and promote technological advance. A federal policy of significant annual increases in real R&D funding, both basic and applied, clearly would benefit both sectors. So would tax incentives for corporate research grants to universities, and both sectors would find common ground in arrangements for joint applied research in university centers, such as proposed by Senator Stevenson in S. 1250.

University research personnel and companies would both benefit from the assignment of patent rights from government-funded R&D. Both would benefit from the several recommendations to expand the dissemination of scientific and technological information, including that from foreign sources. Both sectors should cooperate with government procurement policies designed to stimulate innovation (though it might be uncomfortable), and each might consider using innovative procurement policy on its own suppliers.

The proposals to strengthen the educational system, particularly higher education, with respect to efficiency, quality, and accessibility are of concern to business with its interest in an adequate supply of trained manpower to meet its growth needs. Business input with respect to future labor requirements, and possibilities of applying industrial technologies to the educational sector, could be valuable, Mr. **Dale**. Thank you, John. Are you sure you couldn't hit 100 recommendations?

Mr. **Kendrick**. I thought 99 was more impressive.

Mr. **Dale**. OK. Next, I'm very pleased to introduce Ray Marshall, our former Secretary of Labor, who is presently Bernard Rappoport Centennial Professor of Economics and Public Affairs, at the University of Texas at Austin.

PRESENTATION OF RAY MARSHALL

Mr. **Marshall**. Thank you, Mr. Chairman.

What I would like to do is to put the productivity question in a little different perspective than John Kendrick, who's done outstanding work in this field.

In reviewing his work and that of many others I note two things about the aggregate economic studies of productivity. One is that while they might agree on the list of things responsible for productivity changes, there's very little agreement, as John emphasized, on the weights to attach to the factors on that list; and, second, what a small part of a total productivity slowdown they can account for with all of those factors on their list. Ordinarily, much remains to be unexplained.

I don't find that surprising because productivity is the outcome of all that happens in an economy or enterprise and, therefore, is too complex for the tools of analysis and measurement that we have available to us. Therefore, I think we inevitably will have great difficulty trying to understand what caused the slowdown. The economists simply don't agree on the weights to be assigned to things. There's nothing new about that, of course. Economists don't agree on a lot of things.

It was George Bernard Shaw many years ago who said, "If you laid all economists end to end, they would never reach a conclusion." Somebody more recently said, "If we laid you all end to end, it would be a good idea."

Now it seems to me that the important perspective on this, though, is to recognize that productivity actually takes place within an enterprise at the workplace level, and while the economic environment has a lot to do with that, you don't have to understand what caused aggregate productivity growth to slow down in order to know what has to be done to improve it, and there are many things at the enterprise level that can be done to improve productivity growth.

The obvious factors in the economic environment that are important are the things that John mentioned. In comparing productivity growth in the United States and Japan in the same industries, I am impressed by how much difference a stable economic environment really makes. The Japanese have been able to gain considerable market share by counting on the instability of American firms and they, therefore, have been able to gain market share during downturns and upturns. As John Kendrick emphasized, we usually lose productivity growth during downturns and we also lose the continuity that we would get if we had a more stable environment.

Similarly, of course, technological change and innovation are clearly important, but these, too, are related to stability. During downturns, American firms lose the resources to invest in R&D and that puts them at a very serious disadvantage when they come out of the recession.

A third kind of environmental factor that policy can affect is the quality and cost of resources. Capital costs in the United States are much higher than they are in other countries. That makes it very difficult for our people to compete and to innovate. Labor costs are higher. We are a high-wage country and I hope we stay that way because we ought to make policy on the assumption that we should be a high-wage country and that one of our main objectives should be the improvement in real wages, which is one of the main reasons to concentrate on productivity growth.

Now other factors involved in the productivity slowdown, that the experts disagree about is the relative importance of the energy crisis.

Another environmental factor is our ability to adjust resources out of noncompetitive into more competitive sectors. An important cause of productivity growth during the 1960's was interindustry shifts. There was a movement of resources out of relatively low productivity agriculture and into higher productivity manufacturing and, therefore, the ability to make those kind of adjustments clearly will determine our ability to improve productivity growth.

But as I said, I think that you are likely to gain a great deal more by concentrating at the enterprise or microeconomic level, if you can assume a proper macro-economic environment. Here we have learned a fair amount by international comparisons of enterprises.

One obvious factor is that the kind of management system you have is critical, and many of our management systems have been obsolete and uncompetitive and, therefore, has caused us great difficulty competing internationally. Many of our companies never intended to compete in the international marketplace. They were oligopolistic, authoritarian in their treatment of workers and, therefore, they will either change or they will atrophy.

We have also learned a fair amount about the relationship between job security and productivity because part of the connection is that job security improves management. Now some of our companies understand that, but most don't. IBM understands it and they realize that if you can shift the cost of change to the workers, then you reduce the need to manage, and productivity is created by the management system. I am convinced that you will never be able to get higher productivity growth without worker participation. I believe management's motives have a lot to do with our problem in this country. The Japanese maximize market share and our people maximize short-run profits too much and, therefore, tend frequently to ignore the kind of long-run technological changes that have to be made.

I have worked with a number of companies on productivity questions and one of the things that they tell me that they find most suprising to them in this country is the relationship between quality and productivity. Our people have concentrated too little on quality, but it has a very important and direct relationship to productivity.

Finally, I am convinced also that the industrial relations system has a lot to do with our ability to improve productivity and Quinn Mills is going to talk about that. I will simply say that I am convinced that one of the reasons for our decline in productivity during the 1960's was the deterioration in our industrial relations system and the evidence is pretty strong that what can be called a good industrial relations system could go a long way toward improving productivity. Thank you.

[The complete presentation of Mr. Marshall follows:]

OBSTACLES TO INCREASING REAL WAGES

Ray Marshall

for
The American Economy in Transition: From the
Second World War to the 21st Century

A Symposium on the 40th Anniversary of the
Joint Economic Committee

January 16, 1986

Introduction

There is no more important indicator of an economy's performance than trends in real wages and incomes. Nor is there a clearer sign that the American economy is losing its competitiveness than the inability of its enterprises to operate in international and domestic markets on terms that will make it possible to maintain or improve real wages and profitability. We should therefore be very concerned about the 20-year trend decline in real wages for American workers.

The main purpose of this paper is to outline some of the main obstacles to increases in real wages. This is not an easy assignment because real wages are important consequences of complex economic processes. I begin with a discussion of productivity, because it is fairly well established that in market economies the main room for improvement in real wages is provided by productivity growth. But other forces are involved because productivity itself is a complex processes and the relative weight to be assigned to its components is not very well understood by economists. There is agreement, however, that productivity is heavily dependent on the nature and quality of human resources, technology, management, industrial relations systems, the economic environment, and public policy.

Industrial competitiveness is important because of the internationalization the American economy has subjected high-wage American workers to worldwide competition and therefore has changed the basic nature of the domestic economy and the influence of public policy. Internationalization requires all major economic institutions to meet the viability conditions of international competition. These conditions depend much more on productivity and flexibility than was true of earlier, more self-contained economies.

In my view, public policy failures are the main reason for our failure to use American resources more efficiently, to improve productivity and international competitiveness, to stabilize the economy, and to eliminate the material and human waste from unemployment and slow growth. Our policies are too fragmented, ideological, adversarial, and shortsighted to create the conditions to make it possible for workers and employers to improve real wages and profitability as rapidly as our resources would permit. This is not to deny, of course, that market systems and individual performance are mainly responsible for economic outcomes. But individuals and markets must operate within the framework of *public* policies, institutions, and infrastructures. Relative to our more successful international competitors, our most debilitating shortcomings are in public, not private, systems. Indeed, in a more competitive environment, noncompetitive private systems tend to disappear, but there is no such mechanism to cause the elimination of unwise public policies. Public policy failures can therefore cause or allow competitiveness to erode over a long period of time, as is currently happening to the American economy. Gross weekly earnings in constant (1977) dollars of all workers in private, nonagrictural employment in the United States declined from $187 in 1970 to $170 in 1981. Real wages in manufacturing have been relatively flat since 1973, after increasing at an annual rate of 2.6% a year between 1960 and 1973--peaking around 1970. Gross weakly earnings of manufacturing workers (in 1977 dollars) were $227 in 1983, $231 in 1979, and $208 in June 1982. Median family incomes declined from $23,111 in 1970 to $22,388 in 1981, again in constant 1977 dollars.

The 1985 Joint Economic Committee (JEC) study of income changes of families with children found similar results. The real median pre-tax income of families with children (measured in constant 1984 dollars) declined by over 6 percent a year between 1973 and 1984 after having grown by 4 percent a year between 1947 and 1973. Median real pre-tax incomes of such families were: $28,989 in 1973 and $25,836 in 1984.[1] Family incomes would have declined more except for the increased labor force participation of women--a process that is self-limiting because there are not many families with another wife to put into the work force. If we are unable to reverse the decline in real wages, it therefore will be difficult to reverse the decline in family incomes.

That these changes are due to broad economic trends is suggested by the fact that profit rates also have been declining. Indeed, profit rates actually fell below bond yields in the 1970s and 1980s (see Chart 1). The composite index of profitability based on 1967 as 100 fell to 85.2 in 1974, and was only 93.9 in 1982.[2]

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[1] Jane Seabury, "Typical Family's Income Has Fallen," *Washington Post*, November 29, 1985.

Why Have Real Wages Declined?

The *slowdown in productivity growth* has been a major factor in the decline in real wages for American workers. Although productivity and wage changes are not highly correlated between industries at any given time, the ability to promote the growth in both real wages and total economic output depends heavily on productivity. That is why we must be concerned that productivity growth in the U.S. private business sector declined from 3.1 percent between 1948 and 1967 to 2.3 percent between 1967 to 1973 and has been less than 1 percent since 1973.

As can be seen from Table 1, manufacturing productivity growth also has declined, whether measured in output per hour of employment or per unit of capital. Indeed, output per unit of capital actually was negative for 1973-83 and very small for 1950-73, and in all cases was lower than output per unit of labor. Table 2 compares manufacturing productivity in the U.S. and other countries between 1973 and 1981. The U.S. and Canada have the lowest rates of growth of manufacturing productivity for 1973-83, but all of these countries experienced slowdowns in productivity growth.

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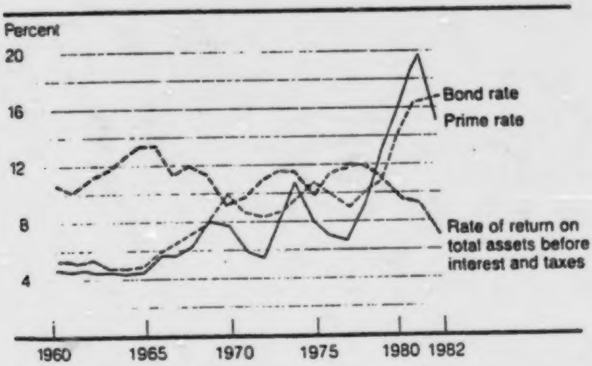
[2] U.S. Department of Commerce, *Handbook of Cyclical Indicators*, 1984, 133.

CHART 1

RATE OF RETURN ON TOTAL ASSETS IN MANUFACTURING CORPORATE BOND RATE AND PRIME RATE, 1960-1982



Source: Scott, Bruce and George Lodge. U.S. Competitiveness in the World Economy, Boston, MA: Harvard Business School Press, 1985, 31.

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TABLE 1

Table . Output per hour, capital effects, and multifactor productivity in manufacturing, 1950-73 and 1973-83

(Average annual percent change)

Period	Productivity			Output[2]	Inputs			
	Output per hour of all persons	Output per unit of capital	Multifactor productivity[1]		Hours of all persons[3]	Capital services[4]	Combined units of labor and capital inputs[5]	Capital per hour of all persons
1950-83	2.5	−0.2	1.7	3.1	0.5	3.3	1.3	2.7
1950-73	2.8	.6	2.1	4.0	1.2	3.4	1.9	2.2
1973-83	1.8	−2.1	0.8	0.9	−1.0	3.0	.0	4.0

[1] Output per unit of combined labor and capital inputs.

[2] Gross domestic product originating in manufacturing, constant dollars.

[3] Paid hours of all employees, plus the hours of proprietors and unpaid family workers engaged in manufacturing.

[4] A measure of the flow of capital services used in manufacturing.

[5] Hours of all persons combined with capital input, using labor and capital shares of output as weights.

Table 2

Manufacturing Productivity Changes, Selected Countries

1950-73 and 1973-83 (average rates of change)

	Productivity in Manufacturing	
	1950-73	1973-83
U.S.	2.8	1.8
Canada	4.3	1.8
France	5.8	4.6
Germany	6.5	3.7
Japan	10.0	6.8
U.K.	3.3	2.4

Source: Economic Indicators, January 1984.

Through its influence on unit costs, productivity influences the competitiveness of American industries. Table 3 demonstrates this relationship. The best performances in both productivity and unit labor costs was by Japan, which actually had declining unit labor costs between 1980 and 1982 measured in yen. Note, however, that Germany and France benefited more from the appreciation of the dollar, which worsened the cost disadvantage of American enterprises.

Table 4 shows the influences of the overvalued dollar on relative wage rates between 1981 and 1984. Note that no country had hourly compensation levels of over 75 percent of the average for the United States in 1984; hourly compensation gaps narrowed during the 1970s--in fact, Germany's compensation level actually was 125 percent of that of the U.S. during the late 1970s.[3]

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[3] U.S. Department of Labor, Bureau of Labor Statistics, *Trends in Manufacturing*, April 1985, p. 53.

TABLE 3

Table . Unit labor costs in manufacturing, measured in national currencies and in U.S. dollars, selected countries, 1973-83
[Average annual percent change]

Country	National currency basis			U.S. dollar basis		
	1973-83	1973-80	1980-83	1973-83	1973-80	1980-83
United States	7.0	8.4	3.9	7.0	8.4	3.9
Canada	9.9	10.2	9.2	7.8	7.8	7.3
France	10.8	11.0	10.5	5.0	11.8	−8.3
Germany	4.4	5.2	2.6	4.8	11.0	−8.4
Japan	2.8	4.5	−1.1	4.1	7.2	−2.8
United Kingdom	14.5	18.5	5.9	9.2	17.6	−8.2

Source: BLS, Trends in Manufacturing, April 1985, Bulletin 2219.

TABLE 4

HOURLY PAY LEVELS ABROAD IN MANUFACTURING INDUSTRIES AS PERCENTAGE OF U.S. AVERAGE, 1981-84

	1981	1982	1983	1984
West Germany	97%	90%	85%	75%
Sweden	108	87	73	72
Netherlands	91	85	78	67
Italy	68	63	62	58
France	75	68	63	56
Japan	57	49	50	50
Britain	65	58	51	46
Ireland	51	49	46	42
Spain	51	46	38	37
Taiwan	14	13	13	15
Mexico	34	17	12	13
South Korea	10	10	10	10
Brazil	17	18	12	9

Source: U.S. Bureau of Labor Statistics.

Some analysts believe that the trend decline in productivity growth has been reversed since the 1981-82 recession, which troughed in November 1982. This is, however, a highly questionable conclusion. U.S. productivity growth at the *peak* of recovery from the 1981-83 recession remained below that of all other OECD countries, whose recovery lagged ours. Moreover, the growth or productivity since November 1982 has been only about half as large as needed to restore the trend rate of productivity growth. As the following BLS data show, recovery from the 1981-82 recession was smaller than for any nine-month recovery period since 1949:

	Compared annual rates of change after 9 months		
Trough:quarter	Productivity	Employment	Unit labor cos
1949:4	-4.8%	2.8%	3.1%
1954:2	2.6	2.5	1.6
1961:1	4.4	0.8	-0.2
1970:4	4.4	3.0	2.6
1975:1	3.5	3.1	4.2
1982:4	2.4	3.9	1.7

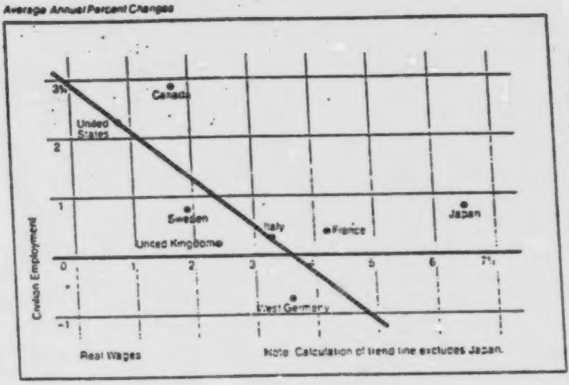
These data suggest that lower productivity was associated with a relatively rapid rate of employment growth. Employment growth, in turn, was associated both with the depth of the 1981-82 recession and the relatively small growth in unit labor costs. As can be seen from Chart 2, there seems to be a rough inverse relationship between changes in employment and changes in real wages, with the exception of Japan, which, during the 1970s, had employment growth rates second only to the U.S. and Canada, but had the highest real wage growth of any country. The United States has had high employment growth than most major European countries, at least in part because policy makers in the U.S. were less concerned about the *quality* of jobs and income support systems for the unemployed. Relative to the Europeans, we were more willing to accept lower real wages and relied more on market forces to fix wages within the framework established by economic and labor market policies that provided less support for workers who were unemployed--as illustrated by Chart 3. The Europeans also had slower labor force growth because they accepted many fewer immigrants and refugees and their post-war baby boom lagged ours. In fact, during the 1970s the U.S. had twice as many immigrants and refugees as the rest of the industrialized world combined.

Comparing labor market developments in the U.S., Europe and Japan over the past 10 years (1973-82) reveals three main trends: 1) steady increases in European unemployment; 2) sharp fluctuations in U.S. unemployment; and 3) virtual stability in Japanese unemployment. It is interesting to note that although U.S. unemployment rates increased during the latter 1970s, the differences between U.S. and European performance narrowed considerably (see Chart 4-A). Furthermore, long-term unemployment has dramatically increased in Europe and, to a lesser extent, in the United States, suggesting structural realignments in employment opportunities in advanced industrial nations (see Chart 4-B).

Relative to the U.S., however, the Europeans have done a better job maintaining real wages. The Japanese, by contrast, have done better than the U.S. with real wage growth, but not as well with job growth; relative to the Europeans the Japanese have better performance in the growth of both jobs and real wages. The Japanese also have had relatively high rates of GNP growth and low levels of inflation (see Chart 5).

CHART 2

CHANGES IN REAL WAGES AND EMPLOYMENT IN EIGHT COUNTRIES, 1970-78



Note: Calculation of trend line excludes Japan.

Source: New York Stock Exchange Office of Economic Research, "U.S. Economic Performance in a Global Perspective," February 1981, p. 44.

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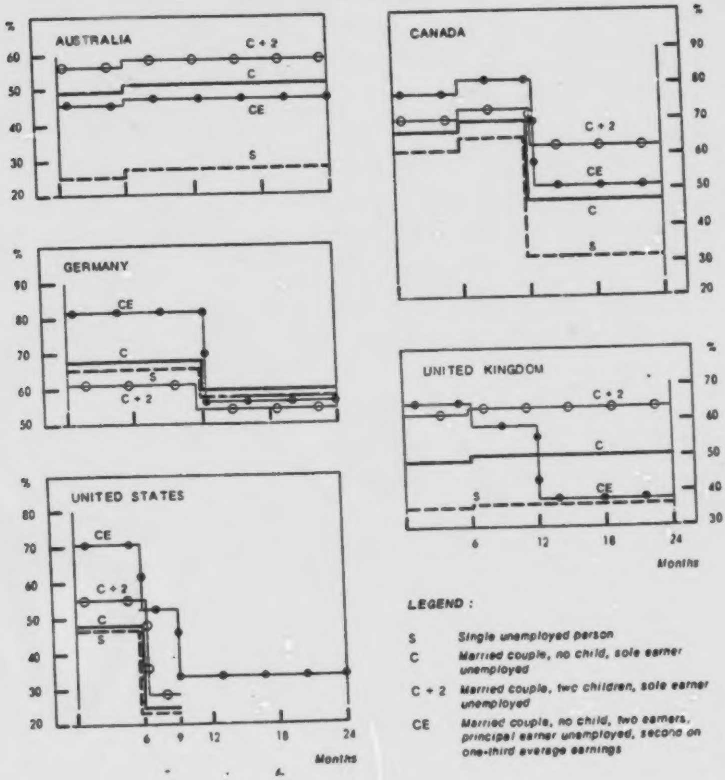
CHART 3

INCOME REPLACEMENT RATIOS FOR HOUSEHOLDS WHOSE PRINCIPAL EARNER, PREVIOUSLY ON AVERAGE EARNINGS, IS UNEMPLOYED

(Averages over six-monthly periods)



Source: OECD, Employment Outlook, September 1984, p. 95

Chart 4-A

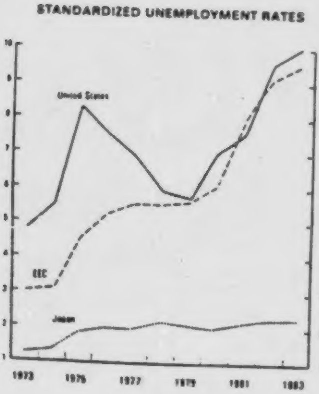
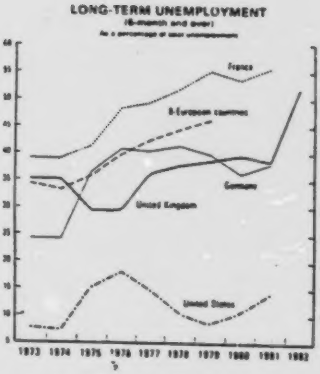


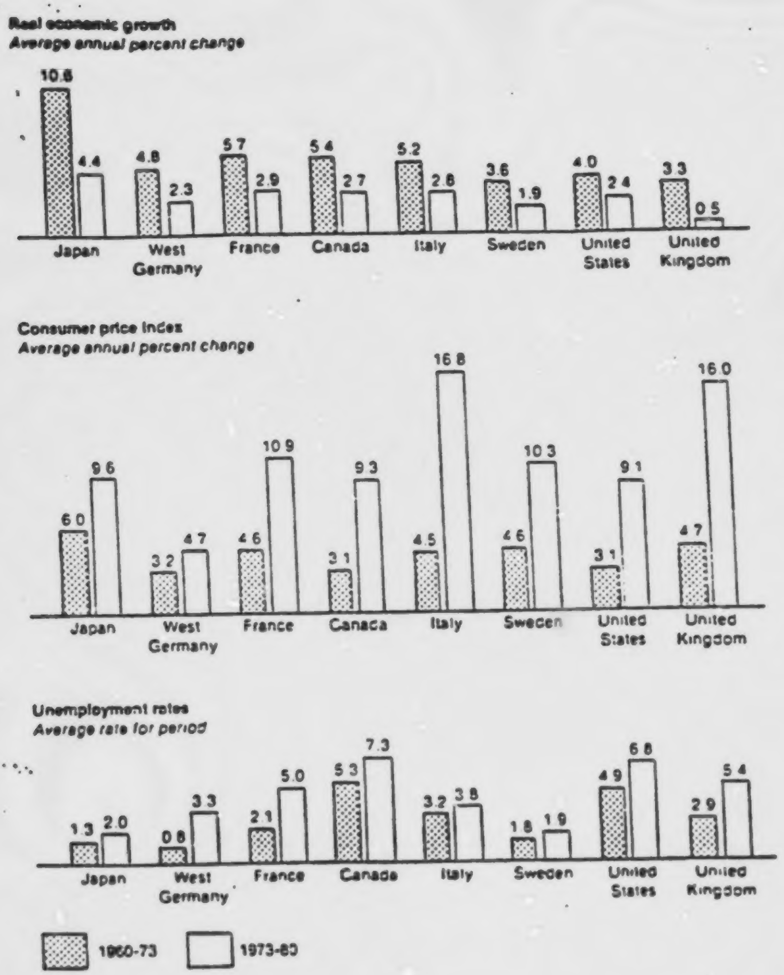
Chart 4-B



Source: OECD Economic Outlook, December 1982.

CHART 5

INTERNATIONAL COMPARISONS OF ECONOMIC PERFORMANCE, 1960-1973 and 1973-1980


Real economic growth
Average annual percent change

Consumer price index
Average annual percent change

Unemployment rates
Average rate for period

Source U.S. Department of Commerce, U.S. Department of Labor, calculated by the New York Stock Exchange, in *U.S. Economic Performance in Global Perspective*, 1981, p. 10.

However, despite declining real wages, the U.S. has not had sufficient job growth to prevent unemployment from rising from an average of 4.8 percent from 1960-70 and 6.3 percent from 1970-80 and 7-10.8 percent so far in the 1980s.

Causes of Productivity Change

Despite numerous studies using a variety of econometric and analytical techniques, there is little agreement on the weights to be attached to the various causes of the slowdown in productivity growth.* Unfortunately, neither our data or our techniques are strong enough to account for these changes. My own assessment is as follows:

While there are monumental technical problems involved in making the assessment, the energy crisis undoubtedly played an important role in the slowdown. We should note, however, that the productivity slowdown started in the 1960s, long before the first energy price shock of 1973-74. However, something associated with the energy crisis appeared to have reduced measured productivity growth. For one thing, the energy crisis caused a substitution of labor and capital for energy, which would reduce productivity measured in terms of labor or capital. Moreover, the energy crisis caused some capital stock to become obsolete, reducing the net capital available. The energy crisis also contributed to economic instability, leading to economic policy confusion and recession; productivity growth always declines during

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*For a good summary, see Economic Policy Council, United Nations Association, *The Productivity Problem:U.S. Labor-Management Relations*, October 1983.

recessions and increases during recovery. Moreover, recessions and economic uncertainty tend to reduce investments in human and physical capital.

There is, however, no agreement over the relative impact of investment on productivity. As can be seen from Table 5, there appears to be no unambiguous relationship between changes in gross or net investment and changes in productivity growth--the period 1956-60, for example, was one of relatively low ratios of net investment to GNP and yet relatively high productivity growth. What is involved, of course, is a complex set of causal forces, no one of which has an unambiguous effect through time. Put another way, investment could have had a strong influence, but was counteracted by other forces or the lags between investments and productivity growth were such as to defy measurements taken at any given time.

Some economists argue that the relevant ratio is not aggregate investment, but capital-labor rations. International comparisons suggest a rough relationship between relatively high rates of growth in capital per employee and productivity growth (see Table 6). Moreover, as can be seen from Table 7, countries with relatively high rates of gross capital formation seem to have relatively high rates of productivity growth.

As noted, however, the relationship between capital formation and productivity is not clear. Table 1 shows the inconsistency of the relationship between capital-labor ratios and productivity. In 1973-83, capital per hour rose by 4 percent a year (from 2.2 percent between 1950 and 1973) while output per hour declined from 2.8 percent to 1.8

TABLE 5

U.S. GROSS AND NET INVESTMENT, 1956-84
(% of GNP)

	1956-60	1961-65	1966-70	1971-75	1976-80	1981	1982	1983	1984
Gross private domestic investment	15.4%	15.3%	15.5%	15.7%	16.5%	16.0%	13.7%	14.27%	17.41%
Plant and equipment	9.9	9.5	10.6	10.4	11.2	11.8	11.4	10.68	11.62
Depreciation	7.3	6.6	6.6	7.3	8.3	9.0	9.4	6.75	7.52
Net investment	2.6	2.9	4.0	3.1	2.9	2.8	2.0	3.93	4.10
Residential construction	5.0	4.8	3.8	4.6	4.6	3.6	3.1	4.00	4.20
Inventory accumulation	0.6	1.0	1.1	0.7	0.7	0.7	-0.8	-0.41	1.58

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE 6

Table 6 Annual average compound growth rates of Capital per employee

	1960-73	1973-80
France	4.8	4.5
Germany	6.2	4.7
Japan	10.6	5.8
Netherlands	5.9	3.4
U.K	4.2	3.4
U.S.	2.1	1.0

TABLE 7

GROSS FIXED CAPITAL FORMATION/GDP
Selected Countries

	1960	1970	1975	1980
United States	17%	18%	17%	19%
Canada	22	21	24	23
France	20	23	23	22
West Germany	24	26	21	24
United Kingdom	16	19	20	18
Japan	30	36	32	32
South Korea	11	24	26	32
Hong Kong	26	19	19	28
Singapore	n.a.	33	35	39
Malaysia	11	16	25	26
Brazil	17	21	25	21

Source: United Nations, Yearbook of National Account Statistics, 1972, vol. 3, table 2A (for 1960): ibid. 1981, vol. 2, table 3 (for 1970, 1975, and 1980).

percent. Moreover, recent BLS studies have not established strong relationships between capital-labor ratios and productivity. To repeat, however, these data do not prove that there is no relationship between investment and productivity, only that it is difficult to measure. However, the relationship clearly depends on the *quality* of the technology involved in the capital investment, not just aggregate capital expenditure, and there are time lags between expenditures and results which are difficult to determine. Despite these measurement problems, there is no doubt in my mind that the proper introduction of technology can and has improved productivity growth. However, just *any* increase in capital spending will not necessarily improve productivity growth.

Other factors commonly assumed to have influenced the productivity slowdown are more questionable; these include: the increased labor force participation of women and young people (who had less experience but were better educated than the average older male already in the work force) and environmental and occupational safety and health regulations (which diverted capital, but also had unmeasured benefits) and in some cases, like the cotton dust standard, actually forced productivity-enhancing technological improvements that short-run profit maximizing companies were not otherwise inclined to make.

Behavioral Factors

Although econometric studies of the reasons for the slowdown in productivity growth have produced inconclusive and conflicting results, there is evidence that productivity can be improved by better management and industrial relations systems.[5] There is evidence, moreover, that *deteriorating* labor-management relations during the 1960s was associated with declining productivity growth.[6]

Studies of management systems in the U.S. and Japan suggest a number of features that improve productivity: greater worker involvement in production decisions and in the development and introduction of technology; job security, which provides flexibility in internal labor utilization and strengthens employers' incentives to finance continuing human resource development programs as integral components of the production process; flexible bonus-based compensation systems that combine basic wages, more egalitarian compensation systems, and bonuses based on company performance; consensus-based decision mechanisms that provide better information to all participants in the production process, greatly improves the quality of decisions; enterprise-based industrial relations systems which, along with bonuses and job security, cause workers to identify more with their companies and to be more concerned with quality and productivity.

The Japanese management system also has achieved much higher employee identification and motivation, as measured by competitive outcomes and attitudinal studies of American and Japanese workers. For example, a 1983 study reported by Public Agenda found that only 9 percent of American workers thought they could benefit personally from improved productivity; 93 percent of similar Japanese workers thought they would derive personal benefit from improved productivity. Of particular importance to improving productivity are systems which give heavy weight to human resource development. There seems to be general agreement among economists that historically a very large part of all improvements in productivity come from improvements in the quality of human resources; physical capital generally has been found to account for no more than 20 percent of productivity growth.[7] This should not be surprising, because developed people are an almost unlimited asset, whereas undeveloped people can be tremendous liabilities. Educated, trained people are better able to deal with change and develop institutions and policies to make effective use of resources and solve problems. The quality of workers' education is, moreover, an important determinant of their ability to adapt to change and assimilate technology.

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[5] See Economic Policy Council, *op cit.*, and Richard B. Freeman and James L. Medoff, *What Do Unions Do?*, New York: Basic Books, 1984.

[6] Weisskopf, Thomas, Samuel Bowles, and David Gordon, "Hearts and Minds: A Social Model of U.S. Productivity Growth," *Brookings Papers on Economic Activity* 2, 1983.

Table 8 A-B provide some information on the quality of human resources in the U.S., Germany and Japan. This table shows that the U.S. ranks high on the *average* level of productivity, but low on productivity growth. the U.S. also ranks relatively high on school enrollments, though other evidence suggests that the U.S. ranks lower on educational attainment in technical subjects. Enrollments in secondary schools are high in Japan but somewhat lower than the U.S. Japanese post-secondary enrollments are relatively low, but the Japanese have

well-developed on-the-job training programs. Japanese blue-collar workers who are regular employees appear to be much better educated than their American counterparts, especially in technical subjects and mathematics.

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[7] See Anthony P. Carnevale, *Human Capital: A High Corporate Investment*, WDC: American Society for Training and Development, 1983.

The U.S. ranks relatively low on industrial unrest, employee motivation and turnover. We rank slightly above Germany on the managerial talent index, but way behind Japan. Note, however, that Germany has fewer days lost due to strikes than Japan, though Japan is very low on this index among OECD countries.

Although there is no question that the Japanese have developed a very effective management system in its export manufacturing sector, I am persuaded that their main competitive advantage relative to the United States is public policy, not their management systems. In fact, few major industrial countries have been as handicapped by public policy as the United States. Some of the public policy contrasts with the United States that have caused the Japanese to gain competitiveness include:

1. Well coordinated macroeconomic policies that have kept unemployment low and productivity and real wage growth high. The U.S. has had uncoordinated macroeconomic policies and very high and unstable rates of unemployment. The instability of the U.S. system has been a major factor making it possible for Japanese firms to target American markets by cutting prices during recessions and taking advantage of inadequate capacity by American firms to meet rising demand to gain market share during recoveries. Since American firms

TABLE 8-A

Human Resource Quality

	United States	West Germany	Japan
Productivity			
Manufacturing Output (per manufacturing worker in thousands of U.S. dollars, 1981)	31.5	24.9	23.7
OECD Rank	(2)	(9)	(11)
Productivity Growth (Average of annual percentage rates of change in real GDP per employee 1977-82)	-0.1	1.5	2.9
OECD Rank	(20)	(10)	(4)
Education			
Education Expenditures (Total as % of GDP, 1981)	8.3	4.7	5.7
OECD Rank	(4)	(16)	(11)
Enrollment in Secondary Education (% of relevant age groups, 1980)	97%	n/a	91%
OECD Rank	(1)	(5)	
Enrollment in Postsecondary Education, 1979 (% of 20-24-year-olds)	55%	26%	30%
OECD Rank	(1)	(8)	(4)

Source: Organization for Economic Cooperation and Development (OECD), Labor Force Statistics, 1983; OECD Historical Statistics, 1983.

TABLE 8-B

Human Resource Quality

	United States	West Germany	Japan
Labor/Management Relations			
Industrial Unrest (Days lost per 1,000 workers)	813	6	31
OECD Rank	(15)	(3)	(4)
Absenteeism (Nonvacation days lost per worker per year)	3.5	7.7	1.6
OECD Rank	(4)	(14)	(1)
Employee Motivation Index*	61.0	65.3	85.3
OECD Rank	(9)	(6)	(1)
Managerial Talent Index*	70.5	68.6	82.1
OECD Rank	(3)	(5)	(1)
Employee Turnover Index*	59	71	90
OECD Rank	(21)	(10)	(1)

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* 0 = low, 100 = high. These indexes are based on subjective assessments gathered from over 1,000 respondents to a survey conducted by the European Management Forum (EMF). Respondents included company chief executives, economic and financial experts, bankers, and the heads of foreign-owned subsidiaries of large multinational companies, as well as key personalities from the press, trade unions, and business associations.

Sources: European Management Forum, from OECD Historical Statistics, 1983; International Labor Organization; Bulletin of Labor Statistics, 1983; Japan Labor Bulletin, November 1982.

are more likely to respond to recessions by laying off workers, the Japanese have had the capacity to quickly gain market share during recoveries, as they did in gaining over 92 percent of the 256K dynamic RAM market.

2. The Japanese have followed policies of providing low interest rates and low capital costs through the banking system to its producers (see Table 9). The U.S., by contrast, has followed policies that have led to huge federal budget deficits and high real interest rates, that not only raise the cost of capital, but also have caused an overvalued dollar and huge trade deficits. DRI, Inc. has estimated that the net after-tax cost of capital between 1973 and 1984 was 0.1 percent for Japanese companies and 5.1 percent for American companies.[8] Table 9 shows the average weighted cost of capital to American industry to have been consistently higher than for other major industrial countries between 1971 and 1981.

3. Japan has followed policies to cause very high personal savings rates whereas the U.S. has followed policies to encourage consumption and discourage savings. Many American policies with respect to credit, taxation, and income maintenance are based on depression-oriented ideas that

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[8] DRI, *Impact of the Dollar on U.S. Competitiveness*, Joint Economic Committee Hearing, Subcommittee on Economic Goals and Intergovernmental Policy), March 12, 1985, p. 12.

TABLE 9

AVERAGE WEIGHTED COST OF CAPITAL TO INDUSTRY, 1971-81

	1971	1976	1981
United States	10.0%	11.3%	16.6%
France	7.5	9.4	14.3
West Germany	6.9	6.6	9.5
Japan	7.3	8.9	9.2

Source: U.S. Department of Commerce, "Historical Comparison of the Cost of Capital," April 1983.

saving is bad for the country. Indeed, the main justification for U.S. trade and other economic policies is that they encourage consumption. Japan's policies, but contrast, have encouraged the growth or productive potential, national economic power, and real incomes. The 1981-82 recession shows demand to still be important, but in an internationalized information world we must give much greater attention to the cost of capital--which means savings relative to investment demand.

4. Japan has followed coordinated industrial as well as macroeconomic policies. These policies are designed to upgrade the productivity of Japan's economy by strengthening the competitiveness of Japanese industry by working with the private sector to encourage the development and use of technology and to actively bargain to get the best terms on foreign technology for Japanese firms, developing consensus on economic policy, and protecting the Japanese market for companies in strategic sectors until they are strong enough to freeze foreigners out themselves. Freezing foreigners out of the Japanese market--the world's second largest--gives them an enormous strategic advantage in developing products, scale economies, and financial resources to compete in international markets.

5. Perhaps the most important contrast between U.S. and Japanese policies besides the consensus-based character of the latter,

is that the Japanese provide a much more stable economic environment where much risk is socialized.

The United States, by contrast, has passive trade policies which are no match for the active policies of Japan and other countries. Our "free trade" ideology encourages ad hoc protectionism, has no sense of strategy, and tends to respond timidly, belatedly and inadequately to strategic policies of other countries. Illustrations of the inadequacies of our policies are the unilateral opening of American telecommunications and financial markets to foreign companies, giving up one of our main bargaining chips in opening foreign markets to American companies. Japanese companies derive considerable strategic advantage from being able to operate unchallenged in the Japanese market--while being able to develop strategic positions in the American market.

A second illustration of our inadequate policies is the administration's recent announcement that it would file charges against Japanese companies for dumping in the sale of the 256K RAM chip after the Japanese had gained over 90 percent of the world market for that strategic component. Ironically, Japanese companies can overcome dumping charges by raising their prices.

We should, however, keep the trade problem in perspective. Although there is adequate room to challenge their compliance with international trade rules, Japanese policies are not mainly responsible for our problems--ours are. Moreover, they are following rational strategies, given irrational U.S. policies. The Japanese recognize, as we do not, that international business is a *strategic* process--where governments and businesses must work closely together.

The whole world has much to gain from an open and expanding international economic system operating within the framework of negotiated, transparent, enforceable rules. We should join with Japan and other countries to negotiate such a system, but we will not be able to do this if we continue an ideological commitment to unrealistic competitive market policies in a world of oligopolies, powerful multinational corporations, and active strategic trade policies by other countries. Nor will we have much power to negotiate acceptable rules if we continue to take unilateral actions that give up our interests without a quid pro quo.

We should take particular pains to avoid worsening our relations with the Japanese, because, as Ambassador Mike Mansfield correctly observes, we have no more important relationship with any other country. This relationship can be improved by more rational U.S. economic policies to improve our competitiveness while opening their markets.

Other Factors Responsible for Declining Real Wages

In addition to slow productivity growth and economic instability, there are other obstacles to the rapid increase in real wages in the United States:

1. The secular increase in unemployment depresses wages and causes large material (as well as human) losses that could be used to increase real wages and public and private physical and human capital formation.

2. Demographic factors--especially the large increase in the

work force because of the baby boomers and the increased labor force participation of women, also have depressed wages.

3. The ability to maintain or increase American wages has been weakened by the internationalized of the American economy. Internationalization has opened up previously sheltered U.S. markets to competition from low-wage workers in other countries who frequently have developed very competitive management systems and use the most advanced technology. Unless American companies have competitive advantages because of technology, skills, differentiated products, or better management systems, international competition will erode American wages, assuming a relatively open international trading system.

4. The relative openness of the American economy to immigration (legal and illegal) increases labor supplies relative to job growth and therefore reduces wages and perpetuates marginal low-wage jobs. Of course, it is impossible to know the number of illegal immigrants but refugees and immigrants (legal and illegal) probably accounted for at least one-fourth of the growth in the American work force during the 1970s. There is some debate about the effects of immigration on employment, but there is little doubt in my mind that it depresses wages of U.S. residents, especially in the absence

of policies to maintain economic growth.*

5. The decline in union strength reduces workers' ability to improve their wages. Although the main obstacles to the rapid increase in real wages for American workers are the other matters discussed in this paper, declining union strength also is a factor. Some argue that unions have no independent power to increase wages because union wage gains are at the expense of non-union workers, but I think that argument is flawed. Unions can and have increased wages by strengthening productivity. Moreover, the "social-cost-of-union" argument assumes competitive markets, which is rarely the case. Where technological, product, or other factors give companies market advantages, unions can share these "rents" with companies, with no adverse impact on non-union wages. Moreover, unions play an important role in protecting and facilitating worker participation in the work place and in public policy matters that are essential to free and democratic societies. Internationalization nevertheless requires unions to be more concerned about the competitiveness of firms than was true in a less competitive environment. Experience also suggests that competitiveness--productivity, quality, flexibility--requires managers to be more concerned about employee security and involvement in

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*See Ray Marshall, "Immigration: An International Economic Perspective," *International Migration Review* 18, Fall 1984, pp. 593-612.

work processes. I do not believe workers can have effective involvement in companies without the independent sources of power that come from the effective right to organize and bargain collectively.

Conclusions

The most important obstacle to the increases in real wages is the slowdown in productivity growth. Whatever the reasons for the slowdown, it is clear that productivity improvements will require investment in physical and human resources, improved management and industrial relations system and, most important, economic policies to promote more effective use of physical and human resources. Improved economic performance will, in turn, require much better international economic policies. We must, moreover, rebuild national consensus for economic growth to promote the full and efficient use of our human and physical resources. We must be concerned about the quality of jobs as well as the number. The most immediate macroeconomic policy objective should be to reduce real interest rates and the value of the dollar by reducing federal budget deficits. However, it would be unwise to reduce budget deficits at the expense of economic growth or public investments in human capital and physical infrastructures. The current account balance should be a specific policy objective in order to prevent growing external debt from undermining the value of the dollar as a reserve currency or unduly burdening future real output and real incomes in order to service large external debt. The most direct way to reduce current account deficits is to return the value of the dollar to its 1979-80 levels by reducing real interest rates through less restrictive monetary policies while federal budget deficits are raised by increased taxes. This will increase exports and reduce imports. Lower real interest rates also would help reduce the budget deficit.

But macroeconomic policies alone will not be sufficient. We need to take measures to greatly strengthen the development of our human resources. Moreover, reducing the value of the dollar could generate long-run inflationary pressures. We therefore should develop selective anti-inflation policies *before* inflation becomes a problem.

We also should develop mechanisms to build consensus over economic policy and to encourage such processes at the industrial, regional and state and local levels. These mechanisms cannot substitute for legislation, management, collective bargaining, or free markets, but they can improve all of these processes by narrowing the range of conflicts and providing much better information, especially about trade offs and limits.

Other measures that would improve economic performance and real wages for workers include:

1. Strengthened investments in civilian research and development.

2. An *active trade policy* to develop an open and expanding trade and finance system within the framework of transparent, enforceable, negotiable rules.

3. A positive adjustment program to encourage the modernization

of industry and the shift of human and physical resources out of noncompetitive industries in an orderly way.

4. Rationalization of federal loan and loan guarantee programs into a single entity with the power to make adjustment loans or for research and development not likely to be financed by existing financial institutions. This entity should be insulated as much as possible from the political process and allowed to raise resources from pooled pension funds, public bond sales, and other sources.

5. Encourage greater worker participation and ownership through labor-management cooperation, employee stock ownership plans and strengthening the ability of workers to organize and bargain collectively.

6. Limit illegal immigration. If it is determined that America has labor shortages in the future, people should be allowed in as legal immigrants, not as guest workers.

Mr. DALE. Thank you, Mr. Marshall.

Next, is Prof. Quinn Mills, Albert J. Weatherhead Professor of Business Administration at Harvard University. He has also served as a member of the National Commission on Employment Policy.

PRESENTATION OF D. QUINN MILLS

Mr. MILLS. Thank you, Ed. That's a very kind introduction.

I will talk for just a few moments about the contributions which labor-management relations might make to significantly enhancing productivity in our country.

Now there is considerable evidence that labor-management relations in both unionized and nonunionized situations can make a significant contribution. When investment bankers look at employee buy out proposals in corporations, for example, they ordinarily assume that there will be a doubling of the productivity level in those companies when the employees are the owners and, in many instances, we have found exactly that to occur. We have foreign companies that buy plants and facilities in the United States and then operate them at levels of productivity roughly double what their American predecessors had been able to achieve.

The reasons for this situation are many but they include the fact that we have developed over the years certain kinds of work practices and attitudes between management and labor which in many situations are profoundly inhibitory toward increases or substantial improvement in productivity.

Now in some companies today a contribution is being made, often because of foreign competition but in many others more or less is occurring than we might expect. In part this is because management and labor in the United States do not give productivity advances a very high priority in terms of their relationship.

Management often puts tight controls on production processes and concerns about cost—narrow- and short-term concerns—above the wider discretion and involvement for workers which, we have a good bit of evidence, contributes to higher productivity.

Top management is more concerned about the balance sheet than the income statement when it looks at the corporation. We are in a period of time in which because of take overs and restructuring what managers are looking for, what the capital markets are looking for is undervalued assets on the balance sheet that can be capitalized now, as a result of a decade of inflation behind us. Top management's attention is not on the income statement and the kinds of productivity increases that can push more dollars down to the bottom line.

Unions in their turn often put their general objectives such as no givebacks or even internal political considerations—since of course the unions elect their leadership and are fundamentally political institutions—above productivity as a goal.

Our labor relations system since the 1930's has as its principal purpose the continuation of the provision of industrial peace and that's a major contribution to productivity because strikes inhibit productivity. When plants are shut down there isn't a lot of productivity.

On the other hand, we don't have many strikes today. The contribution which industrial peace can make to the American productivity record has been made and it is not enough. There is clearly the need for substantially more.

Now in some companies changes have gone so far as to be fairly described as a new-work system and one which enhances productivity. The essence of the new system is to combine a more responsible role for employees, with a broadened job, lesser supervision, enhanced employment security, and gain sharing, whether productivity-sharing or profit-sharing or cost-saving sharing.

The evidence is that the new system is more productive than the old in both the union and the nonunion environment. The old system stresses narrowly defined jobs: "keep it simple, stupid," tight supervision, the continual risk of layoffs, and the traditional hourly wage. This remains the most common process in American industry.

We have discovered that under this old system what the companies gain in efficiency in control of their workers and the production process tends to be lost in lack of motivation and lack of commitment of their employees. And economic adversity does not automatically guarantee a shift. It just is not true, despite what most economists think, that given an incentive the proper and necessary actions will be taken. Instead, in adversity, most managements retreat to tighter controls. If it's tight controls that cause the problem in the first place, then adversity exacerbates it. It reminds me of what has often been called the surgeon's lament—he says, "Damn it, I cut it off again and it's still too short."

We go into this problem with tight controls and when we experience the problem intensely we go to tighter controls.

Now traditionally in the U.S. management views productivity as its responsibility and the unions view job security as theirs, but in recent years neither has been able to accomplish very much with this division of effort. The companies can't get productivity up if the employees don't cooperate and the unions can't deliver job security when the companies' positions are being eroded in the marketplace.

A major contribution which American labor relations could make to improving productivity would be for management and unions to reverse their traditional roles. Unions can today do more for productivity than companies can and management can do more than labor can for employment security. This is not a heretical notion outside the United States, although it is here. If management and labor in our country would each assume a new responsibility, the other's responsibility, then American productivity, employment security, and competitiveness could all simultaneously be enhanced.

[The complete presentation of Mr. Mills follows:]

D. Quinn Mills
December 19, 1985

LABOR-MANAGEMENT RELATIONS AND PRODUCTIVITY

Executive Summary

Labor-management relations have a potentially significant contribution to make to productivity advances. Though in some companies, a contribution is being made today, in many others far less is occurring than might be expected. In part this is because management and labor do not give productivity advances a very high priority in terms of their relationships. Management often puts tight control of production processes and costs above wider discretion and involvement for workers. Unions, in their turn, often put general objectives such as no give-backs or even internal political considerations above productivity as a goal.

Despite these limitations, progress has been made in the productivity area in recent years, due in part to the challenge posed by foreign competitors. In some companies these changes have gone so far as to be fairly described as a new work system, one which enhances productivity. The essence of the new systems is to combine a more responsible role for employees (via broadened jobs), lesser supervision, enhanced employment security and gain sharing. The evidence is that the new system is more productive than the old in both union and nonunion environments.

The old system stresses narrowly defined jobs ("keep it simple, stupid"), tight and extensive supervision, the continual risk of layoffs and the traditional hourly wage, this system remains the most common in American industry.

Prepared for the Joint Economic Committee of Congress.

A transition from old to new is made difficult by the strong attitude in this country that productivity is job destroying, not job creating. Managers justify proposed capital investments by citing the number of jobs they will eliminate. Unions and workers see productivity advances as displacing workers into unemployment lines. Despite some amelioration in recent years, these attitudes remain very deeply engrained in much of our management and employee work force and are a major factor in limiting the contribucion which labor-management relations can make to productivity improvement.

Traditionally in the United States management views productivity as its responsibility, and unions view job security as theirs. But neither is able to accomplish very much with this division of effort. The major contribution which American labor relations could make to improved productivity would be for management and unions to reverse their traditional roles. Unions can today do more for productivity than companies can. And management can do more than labor for employment security. If each will assume a new responsibility, American productivity, employment security and competitiveness can all be enhanced.

The Impact of Labor-Management Relations on Productivity

Labor-management relations are deeply involved with productivity in American industry. They affect in important ways both the level and rate of increase in productivity, and are in turn affected by it. Improvements in labor-management relations hold very substantial promise for increasing productivity in many American firms and industries.

Nor is the potential for improvement limited to the unionized sector of American industry. In many instances the unionized sector sets standards or patterns in the structure and pace of work and in the attitudes of management and labor toward one another which are replicated to a degree in the nonunionized sectors of industry. The recent decline of union strength has probably lessened the pattern-setting influence of the union sector, but it has not extinguished it.

Labor relations in the union sector in this country remains primarily about industrial peace. This is not an insignificant objective. In recent years we have had a very low level of time lost due to strikes or other work stoppages, and this has undoubtedly made a contribution to making American productivity higher than it otherwise would have been.

But industrial peace makes only a limited contribution to enhancing productivity. It increases productivity only by the device of not disrupting it.

Industrial peace has made its contribution. It is important; but not enough to ensure the competitiveness of U.S. firms in the international marketplace. Today, despite the fewest working days lost to industrial disputes in decades, American productivity advances lag behind our major foreign competitors. A more positive contribution is being called for.

Despite the increased consciousness of marketplace competition among American managers and workers, the American productivity record has not been exemplary in many industries in recent years. Aggregate data suggest that in manufacturing we are still behind our key competitors in the rate of advance of productivity. Hence there is ample opportunity for labor and management to join in making contributions to improving productivity in our factories.

Productivity is more important than either American management or labor give it credit for. It is the long-term engine of economic growth as well as of international competitiveness. Recognizing this, scholars and public officials have in recent years advanced imaginative proposals by which management and unions can improve productivity.

But in the U.S. economy long-term is often subordinated to short-term, and this is true not only of management approaches but of those of the unions as well. While management tends to sacrifice productivity advances to short-term profitability, unions tend to sacrifice them to the short-term considerations of intra-union politics.

Labor relations is part of the U.S. system. It is not managed differently than other things by either management or union. For the most part whatever shortcomings characterize American managers or union officials, tend to characterize their relations with each other as well.

This observation should give us considerable pause about the potential of various schemes in advancing productivity. They have a role but it is a difficult thing to convert thinking about productivity to an appreciation for its long-term importance, when this must be done in isolation from other considerations which are still located as short-term

In American labor relations considerations about productivity tend to be not only short-term but also to have a low priority. For example, management may want to reassign people to enhance productivity, but the union objects to the inconvenience involved for some employees. Alternatively the union may want to provide people more information about production, believing that it will help improve productivity. But management fears the union will use the information against the company.

Again, the union may ask the company to give its employees advance warning about major changes in production methods or staffing levels, arguing that with such advance notice employees can cooperate better in the production process. But management often feels that forewarned is forearmed for the union against the company's intentions.

And despite much rhetoric, American managers often don't give productivity as high a priority as cost control or management control of the production process. And Union's despite concern about competitiveness are often reluctant to see productivity increased.

So, while it is useful for observers and public officials to think of proposals by which productivity can be enhanced, an Achilles hill of such schemes is often that neither management nor labor puts a high enough priority on productivity to sacrifice other objectives to it.

In part this is because companies and unions define success in industrial relations primarily in terms either of achieving their own goals vis-a-vis the other, or of securing an absence of work stoppages. Neither ordinarily includes best practices in management and improvements in productive efficiency as a major part of labor-management relations objectives.

Hence there are four general types of impact which labor management relations may have on productivity:

1. It may obstruct productivity by design of one party or the other;
2. It may obstruct productivity by omission or neglect;
3. It may enhance productivity to a degree by not obstructing efficiency;
4. It may enhance productivity by the intent of the parties.

In America today some companies and unions are embarked in the last of these courses, and their experiences are the most interesting to study, as we shall see below.

Traditional Management Approaches to Productivity

Most factors that contribute to increased productivity are in the domain of management. This is true in both unionized and nonunionized environments. Yet, while we often assume that in a nonunion facility management is free to institute methods that will yield high productivity without objection, this is not necessarily so. Nonunionized workers will sometimes act in concert, especially as a result of shared fears or apprehensions, to oppose technological change. Furthermore, nonunionized workers often cooperate surreptitiously to set a slower pace of work or a lower level of production than the company desires.[1] The same sort of thing happens also, perhaps more easily, in the union context. For example, the warehouse director of the Eastern Conference of Teamsters commented that too often it is the case that a new warehouse employee will pick 125 to 135 items from the shelves each hour. But, after acquiring regular employee status and the protection of seniority, the same employee will fall back to much lower rates of production.[2]

Employers have traditionally responded to such problems in one of three ways:

1. By tightening discipline
2. By imposing changes in production methods
3. By attempting to persuade workers to assist in raising production levels

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[1] In 1931 S.B. Mathewson wrote a classic study of such practices which, is unfortunately, now out of print: Restriction of Output Among Unorganized Workers (New York: Viking Press, 1931).

[2] Morand Schmidt, speech of the Teamsters Warehouse Division meeting in Boston, cited in Bureau of National Affairs, Daily Labor Report No. 163, August 21, 1975, p. A7.

There are no statistics to indicate the general success or failure of these efforts.

To a degree, the persistence of management frustration about the level of productivity in American society reflects failures on the management side. Too often, outdated and inefficient practices are so much an accepted part of an enterprise or institution that management doesn't think they can be altered. So, rather than implementing improvements through discussions with workers and supervisors, management simply complains about bad work habits. If a problem exists that merits criticism, then it also deserves a serious effort by management to improve the situation.

But if management wishes to obtain changes in the behavior of workers, it must be prepared to put its own house in order where a change is warranted. Managers often fail to raise the issue of work productivity because they are afraid to reveal the limitations of their own knowledge about what is really going on in the work place. For example, surveys of companies have been conducted regarding their methods of measuring employee performance. While most large companies have methods of evaluating the performance of production workers, only a minority have any actual measurements of productivity. And for office employees, while most companies have some form of performance evaluation program, only a small minority have any productivity measure.

Managers are often afraid to raise the issue of productivity for fear it will open the door for discussion of other aspects of management policies. Consequently, in many collective bargaining negotiations the work standards of the shop floor are studiously ignored by both management and union officials, neither wishing to demonstrate how little it knows about the actual day-to-day processes in the work place or to initiate a discussion that might get out of hand.

If a management is serious about wanting to improve productivity in a facility in a substantial way, it must make a substantial effort. A complete plan for attempting to obtain higher productivity in the work place would include the following elements:

- A study of the sources of difficulty
- The development of a program to remedy the defects
- An attempt to persuade the workers and union, if any, of the need to improve productivity
- A willingness to alter managerial practices that contribute to lessened productivity
- A willingness to tighten work discipline
- A willingness to reward success by workers in increasing productivity

Unfortunately, many managements are not prepared to take this difficult route. Instead, they look for some simple solution.[3] There are many people who are willing to sell managers some particular scheme to improve productivity without much effort. In 1975 a study listed nine such schemes, any one of which might have its place in a serious program to improve productivity, but none of which was of much value when relied on in place of a more comprehensive effort. The nine "fallacies of management" are given in Table 1.

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[3] Bruno Stein, "Management Rights and Productivity," The Arbitration Journal, 32:4, December 1977, pp. 270-278.

Table 1

Fallacies of Management in Trying to Increase Productivity

1. Following the leading companies (i.e., doing just as others do)
2. Decentralizing (i.e., shifting responsibility)
3. Leaving the problem to the personnel department
4. Treating the work force as a fixed asset
5. Issuing platitudes about productivity in the company's own publications
6. Relying exclusively on computer printouts (i.e., statistical information) for evidence about operations
7. Trying to speed up the workers' pace
8. Trying to improve jobs
9. Hiring a consultant

Source: A.A. Imberman (president, Imberman and de Forest, management consultants, Chicago), "The Low Road to High Productivity," Conference Board Record, 12:1, January 1975, pp. 29-40.

Traditional Union Approaches to Productivity

Managers and the general public are, with few exceptions, of the view that increased productivity is to be encouraged. The benefits from increased productivity in terms of increased output and potentially lower costs and prices seem obvious. Workers and unions are less certain. Increased productivity may manifest itself in layoffs, so that workers fear loss of their jobs. Or increased productivity may require greater effort or other changes that the workers do not welcome. For these reasons, it is unusual for the workers directly affected to welcome increasing productivity, unless their concerns are somehow accommodated.

Unions are in the most ambivalent position. On the one hand, unions recognize the potential benefits of increasing productivity in terms of general living standards. They also recognize that increasing productivity may provide a margin out of which employers may pay better wages. On the other hand, the unions often reflect the concerns of workers about their job security or the resistance of workers to the changes in their jobs that accompany increased productivity. As a consequence of this divided attitude, unions ordinarily attempt to keep the pace of productivity change to a manageable level, while also attempting to obtain for the workers a share of the benefits of increasing productivity.[4]

These differing attitudes toward increasing productivity set the stage for problems between management, unions, and workers. The various ways in which the problems are dealt with are the subject of the new few pages. A special aspect of this topic is the misunderstanding that surrounds it. Managers and the public find it difficult to understand why workers and unions would resist progress of the type that yields increased productivity and often view such resistance as evidence of ignorance and stubbornness. Workers and unions, in contrast, find it difficult to understand why they should be expected to accept with equanimity what they perceive to be a threat to their livelihood or comfort, or both.

In the 1970s the country experienced bitter and well-publicized strikes over efforts by companies to improve productivity by changing technology, staffing levels, or working rules. In the 1980s there have

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[4] Thomas R. Donahue, "Technology: Using It Wisely," AFL-CIO American Federationist, 86:9, September 1979, pp. 5-8.

been far fewer of these. The reasons may be that unions are less opposed to productivity increases even by the means listed above, or that the strike is a less useful weapon in today's economy and is so less of lesser resort. The latter explanation is most likely the case. Should the economy improve considerably, union opposition to productivity enhancing actions by management might well result in a new wave of work stoppages.

Job Security Versus Employment Security

Labor and management traditionally held conflicting views over what increased productivity means. recent contract negotiations in auto industry suggest, however, that a new, more common view of the problem may be developing.

Some unions have opposed the introduction of new technology or other changes designed to enhance productivity, fearing members' jobs would disappear. But, the most recently negotiated agreement between General Motors and the United Auto Workers suggest that when both sides can begin to think of employment security (guarantees of employment at a company) rather than job security (security in a specific detailed job defined by a job description or history) progress can be made toward meeting the concerns of both parties in this controversial area.

In September 1984, local leaders, followed by the rank and file, ratified a new 3-year agreement with General Motors that provided moderate wage gains plus some innovative agreements for solutions to employment security. A $1 billion plan to fund a "job opportunity plan" was established under the unique agreement. Funds from the plan will be used to support the job search efforts of GM workers who lose their jobs because of outsourcing or automation. The agreement encourages retraining and entrepreneurship for those displaced by means of designation of up to $100 million to support new business ventures.

Innovative employment security provisions have also recently been agreed to in the airline industry and in communications. The recasting of the problem from job security to employment security enabled labor and management to search together, not as adversaries, but as joint problem solvers for solutions to one of the major problems affecting the industry.

The New Productivity Systems and Labor-Management Cooperation

If there is to be an effort made to improve productivity in a particular facility, or company, or even an industry, it must be a joint effort by management and labor. Neither can accomplish much without the other. This is true regardless of whether or not the workers are represented by a union. The workers and the union, if there is one, must cooperate, because if they choose not to, they can undercut management's attempt to increase efficiency by not making an effort, by absenteeism, by errors, and so on. But management can undercut a good labor relations climate by failing to provide tools and materials, by failing to schedule work well, or by failing to supervise properly, which permits some workers to loaf while others work hard.

The old system of productivity improvement sought by management relied on simple repetitive jobs ("keep it simple, stupid"), and direct supervision of employees. It necessarily entailed a steep and expensive hierarchy of middle managers.

The new system offers more complex (or enriched) jobs, greater self-supervision by employees, and a simpler or flatter organization structure.

What was gained by the old system in efficiency was lost in poor employee motivation; what is apparently lost by the new system is managerial control is gained in employee motivation, initiative and performance.

The new systems require a different type of labor-management relations, however. An adversarial system is inconsistent with the control management has relinquished, and with the responsibilities employees have assumed. The new system requires labor-management cooperation.

One method of labor-management cooperation to improve productivity involves joint labor-management productivity committees. These committees are composed of representatives of labor and management who meet regularly to discuss matters of mutual interest. Such committees are sometimes organized only at the plant level, and sometimes at higher levels as well. The committees are not a substitute or an alternative to collective bargaining; they require a mature collective bargaining relationship in order to have a favorable environment in which to function.

Labor-management productivity committees may multiply quickly in a crisis. During World War II, for example, several thousand joint committees were organized in plants to cut waste, improve productivity, and bolster morale. In the aftermath of the war most of them disappeared.[5]

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[5] National Commission on Productivity and Work Quality, Labor Management Productivity Committees in American Industry (Washington, DC, May 1975). Also, William Gromberg, "Special Study Committees," in J.T. Dunlop and N.W. Chamberlain, eds., Frontiers of Collective Bargaining (New York: Harper, 1963), pp. 235-251.

About 35% of all collective bargaining agreements provide for joint labor-management committees to explore specific problems, such as productivity. And the number of such committees has been rising recently.

Current examples of the joint committee approach include the labor-management committee of the Jamestown, New York, area, the employment security and plant productivity committees of the basic steel industry, and the joint committees of the Scanlon Plan. The Jamestown committee originated in the concern over the loss of plants and jobs because of bad labor relations in this community of 60,000 people, located in western New York state. The Federal Mediation and Conciliation Service, which includes representatives of more than 30 companies. Labor-management committees at the plant level were important features of the program. Ten plants initiated special projects to improve productivity, including a training program for skilled workers, a redesign of jobs, and a new incentive program.[6]

In the basic steel industry, the United Steelworkers, and the 10 basic steel companies party to the national agreement first decided to establish labor-management committees in 1971. The effort began by the organization of an industry committee. This committee then set up joint advisory committees on productivity. In 1975 about 250 plant-level joint committees were in operation. Typically, each committee includes four union and four company representatives. Most committees meet monthly, or more frequently, on an informal basis.

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[6] Three Productive Years (Jamestown, NY: The Jamestown Labor-Management Committee, 1975).

The progress of the cooperative relationship has not been smooth. Originally the committees were called simply "productivity committees." There was such opposition from some local unions to the committees that at the 1972 convention of the steelworkers the union decided to seek certain changes, in both the names and the functions of the committees. And the president of the steelworkers' union, I.W. Abel, though a strong supporter of the cooperative effort, felt compelled to oppose management's alleged use of the productivity committees as a camouflage for a speedup. Nevertheless, the steelworkers' convention endorsed the continuation of the program, and it was included in the 1974 basic steel agreement under the new name of "employment security and plant productivity committees."

At the time of the 1977 negotiations, the joint productivity committees were largely inactive. They were almost dropped from the 197-1980 agreement but were retained for what were called "face-saving"[7] purposes. but under the pressure of the difficult economic situation of the steel industry in the 1980s, labor and management negotiators made a major effort to revitalize the committees. Among the possible contributions of the committees are declining absenteeism, improved quality, reduced waste of materials, and improved plant housekeeping.

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[7] "Joint Steel Productivity Program ... Said To Be in Doldrums," Bureau of National Affairs, Daily Labor Report No. 211, October 31, 1978, p. C1.

Productivity Bargaining

In order to acquire some perspective about labor-management relations and productivity, it is useful to recall that in the 1960s and 1970s much attention focused on a procedure referred to as "productivity bargaining." The essence of this concept was that "changes in working practices that raise output per man hour are implemented by employees in return for higher rates of pay."[8] Alternatively, productivity bargaining may be described as the employer's receiving from the union a quid pro quo for a wage increase, in the form of a relaxation or modification of working practice that will result in greater productivity.

Productivity bargaining was not new. Employers in certain fields have long entered negotiations with labor unions with a list of demands that would, if agreed to by labor, increase productivity and thereby reduce the employer's costs. What was new was the degree of attention being devoted to the subject. To say that there is a corresponding increase in the success of productivity bargaining would probably be incorrect.

In some cases companies practiced productivity bargaining with some success. An official of one large American corporation described his company as going after individual items to save money. The approach was very specific. The company persuaded or embarrassed the union and, by persistence in negotiations, obtained the removal of costly but inefficient items. An example, cited by the same management official, involved the company's paying for setup time on machines. In the past, certain workers had come in early to get the machines running by starting time, and the company had paid them 15 minutes' time for this. Later the plant went to a continuous, three-shift operation. The machines were now running constantly, and no setup was involved. Yet 12 years after the company went on three shifts, it was still paying setup time. The company's attempt to get this costly practice eliminated constituted, in the company's view, productivity bargaining.

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[8] E.H. Phelps Brown in the foreword to Ronald Edwards and R.D.V. Roberts, Status, Productivity and Pay: A Major Experiment: A Study of the Electric Supply Industry's Agreements, 1961-1961 (London: Macmillan, 1971), p. xii.

Productivity bargaining was far more complex and difficult than it sounded, however. Not only did the unions or workers who are directly involved often resist the company's initiatives, but additional burdens were placed on management. Companies were required to study their production processes, learn where inefficiencies were, and determine which improvements would be most beneficial. And even when a good case for change would be made, it too often took a crisis to get unions to agree to improvements in efficiency.[9]

When productivity bargaining did proceed, it had further pitfalls. First, managements often gave away too much. Productivity improvements resulted from capital expenditures, training expenditures, and similar factors as much as from concessions made by labor. If a disproportionate part of the savings gained from productivity improvements was obtained by labor, the company experienced financial difficulties. Second, when one group of workers in a plant or industry got additional money because it relinquished certain conditions, others demanded the same money without giving up anything. And often these other groups were prepared to strike. Thus, the actual cost to the company of obtaining a concession was much higher, because of secondary increases, than it had first appeared to be. In fact, workers often bitterly resented seeing other workers receive financial benefits for giving up uneconomic practices. They saw this process as one in which the company rewarded those who slowed it up in the past. For these reasons, productivity bargaining was complex and hazardous and more often involved small gains than large breakthroughs. Hence it has not played a major role in the American scene in the 1980s, and though it continues in the form of work rule "give-backs" remains a difficult process.

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[9] Robert B. McKersie and L.C. Hunter, eds., Pay, Productivity and Collective Bargaining (London: Macmillan, 1973). Also, Lincoln Fairley, Facing Mechanization: The West Coast Longshore Plan (Los Angeles: University of California Institute of Industrial Relations, 1979).

Concession Bargaining

A widespread response to the difficult economic times of the early 1980s was the growth of concession bargaining. Historically, in good economic times, unions have come away from the bargaining table with higher wages, better benefits, more or better work rules or rights under the contract. A concession bargain is one where the new collective bargaining contract provides less than before: fewer rules and benefits, less money.

Although unions and the employees they represent are not, of course, pleased with a concession contract, some see it as a necessary response to the long-term economic conditions of an industry or the financial weakness of a given plant or company. But concession contracts are ratified by the membership only when a majority is convinced that they will save jobs or the company and/or provide employment security in the long run. Some companies have demanded concessions from employees where they were not clearly needed. In other words, some companies "cried wolf." This will make the task of developing labor-management cooperation to deal constructively with the common problems faced by management and labor more difficult.[10]

According to a survey on concession bargaining, unions have most frequently traded off immediate wage increases or benefits for more employment security. This is a change from the historic union position that has been to push relentlessly for job security--guarantees for specific jobs, rather than employment security--guarantees for overall employment levels. Table 2 shows that unions are now willing in some instances to trade off specific jobs for employment security on behalf of their members. They are also now more willing than in the past to grant more flexibility in work rules governing the workplace in job assignments, hours of work, seniority, wages, incentive pay and teamwork, in exchange for employment guarantees.[11]

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[10] For a fuller discussion see Daniel Quinn Mills, "When Employees Make Concessions," Harvard Business Review, 61:3, May-June 1983, pp. 103-113.

[11] "A Work Revolution in U.S. Industry--More Flexible Rules on the Job Are Boosting Productivity," Business Week, May 16, 1983, p. 100.

Table 2

What Unions Sought in Return for Concessions[a]

	Percentage of situations in which company sought concessions
More job security	46
No-layoff policy	17
Guaranteed number of jobs	17
Earnings protection	17
To represent more employees	23
Role in corporate governance	31
Consultation on investment	8
Changes in bargaining structure	8

[a] Data derived from interviews with 35 companies.

Source: Daniel Quinn Mills, "When Employees Make Concessions," Harvard Business Review, 61:3, May-June 1983, p. 108-109.

Productivity and Pay

Rather than productivity bargaining, the 1980s have concentrated on gain-sharing as a potential source of productivity improvement.

Incentives

The oldest form of gain sharing is the individual incentive plan. Pay systems can be designed to reward employees directly for their individual performances. Many companies utilize such systems. These systems depend on a careful delineation of the elements of a job and on the setting of standards for the level of production expected. Records are kept of each worker's daily output, and the workers' rate of pay depends on the amount of work done, measured against the established standard. A minimum rate of pay protects those workers who fail to meet the production standards, whether because of material shortages, machinery breakdown, or simply failure to perform. Ordinarily, however, a worker who repeatedly fails to perform well will be dismissed by the company.

Sometimes incentives apply not only to individuals, but also to a group. When a group incentive plan exists, each member of the group receives a certain proportion of the pay allocated to the group as a whole.

The most carefully systematized incentive programs are run by industrial engineers (professional employees who establish production standards). Basically, an industrial engineer observes workers performing a task and takes measurements of the time they require to complete it. From these measurements, the engineer develops a standard that the average worker is supposed to be able to meet. In one of the more popular systems, one widely used in textiles and apparel manufacturing, the company pays for units of production; the basic unit is a minute of work. A standard of work volume is, therefore, the 60-unit hour. Most production workers can exceed this and therefore earn more money. An incentive system is said to be "loose" if too many employees exceed the standard by too much. Generally a good system should not permit the expected average production volume for an employee to get above 20% beyond the standard, that is, beyond a 72-unit hour.

A company's staff of industrial engineers not only does time studies, but also sets pay rates and tells the employees about the rates and about changes in the rates. Sometimes the incentive system is so crucial to the profitable operation of the firm that the industrial engineers even administer the payrolls of the company.

An incentive system must be kept up to date if it is to be effective. Changes in materials, machinery, and know-how cause standards to loosen in time. If standards become too loose, an incentive plan may be said to be "demoralized." In a demoralized plan workers meet their production quotas very quickly and have a great deal of leisure time. While such a situation may be comfortable for the workers, it often leads to bankruptcy for the firm.

On the other hand, the attempts of management to keep an incentive system up to date are a constant source of labor relations troubles. Workers often resent time studies when the studies bring technological improvements and the subsequent imposition of tighter production standards. The result is that, while many companies like the idea of using incentives to pay for workers' performance, they are unwilling to accept the problems that keeping an incentive system current entails. In consequence, incentive systems are less common in American industry than the more simple procedure of an hourly rate of pay.

Wage Rates

Wage rates can also be adjusted to take account of rising productivity.

Frederick Taylor the originator of the time-and-motion approach to job design and the apostle of "scientific" management in increasing productivity coupled increased productivity and increased wages. Testifying to a Committee of the United States House of Representatives in 1912, Taylor said,

> "It is one of the principles of scientific management to ask men to do things the right way, to learn something new, to

> change their ways in accordance with the science, and in return to receive an increase of from 30 to 100% in pay..."

In the late 1940s automatic wage increases, so-called "annual improvement factors" were placed in labor contracts, in order to reflect improvements in productivity. But such automatic increases were predicated, as was Taylor's "principle" quoted above on worker acceptance of management direction as the fountain-head of all productivity.

A further problem with productivity-based wage adjustments is the general confusion about productivity and pay that exists in public discussions and academic analysis today.

Thus, women and minorities who make up a larger proportion of the work force than in the past are blamed for part of America's productivity slowdown. The argument goes as follows: women and minorities are less productive. How do we know? because they are paid less and the market values contributions correctly. But why are they paid less? Because they are less productive.

The argument is circular, and unconvincing. That women and minorities are paid less seems certain; but that they are less productive employees is not demonstrated convincingly by any studies of which I am aware.

Today, managers want intelligent participation and commitment from employees, not only blind obedience, and workers are often unwilling to grant blind obedience. The result is a turn away from wage rate increases as a quid pro quo for productivity increases and the development of more complex compensation plans.

Gain-Sharing

Gain sharing plans take the form of profit-sharing or cost-savings sharings. Profit sharing ties employee compensation to the fortune of the company, but also to events outside a workers' control. Cost-saving sharing tries to tie compensation tightly to the things on which a worker can have an impact. Both provide group incentives, not individual incentives.

But gain sharing alone is not enough to enhance productivity. A mechanism for workers to contribute knowledge and ideas is needed. Hence labor-management committees of some sort accompany many gain sharing plans.

Gain sharing is becoming more popular. About 25% of U.S. manufacturing companies share profits with employees.[12] Another estimate suggests that there are at least a thousand gain-sharing plans in the U.S. today.[13]

Certainly these plans are helping to improve productivity to some degree in American companies. But the process is not a simple one to manage.

Cost Savings Plans

The limitations of an individual or group incentive plan led to the development of another type of compensation system. Named after one of its most important developers, Joseph Scanlon, the Scanlon Plan is used by some firms and unions as a method of rewarding the employees of a company as a whole for exceptional performance. It is not an incentive plan, nor is it a profit-sharing plan, although it is often mistaken for one or the other. Instead, it is a "cost-savings sharing plan."[14]

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[12] Randolph M.Hale, "Managing Human Resources," Enterprise, 9, 5, June 1985, p. 8.

[13] Edward E. Lawler III, "Making Performance Pay," Enterprise, 9, 5 (June 1985), p. 23.

Joe Scanlon had experience as a union official in the basic steel industry. That industry has for years been a major user of individual and group incentives, and remains so today. But Scanlon was very much aware of the limitations of incentives. Not only did they tend to become demoralized over time, but even when the standards were up to date, they had disadvantages. In a plant with individual incentives, each worker had an interest in getting his or her own job done as quickly as possible without regard for the impact of the job performance on anyone else. Quality of production suffered, conflicts developed between employees, and workers had no desire to take actions that would help other workers' production but not their own. The result was an unpleasant, unproductive work place, in Scanlon's view. Because everyone was out for himself or herself, the whole operation was less productive and more expensive than it needed to be.

But, Scanlon thought, no one benefited by this: not workers, whose earnings were lower than they could be; nor the company, whose profits were less than they might be. How, he wondered, could the system be improved? His solution, the plan that bears his name, has three basic elements: a philosophy of cooperation, a suggestion system designed to increase efficiency and reduce costs, and a formula to permit a bonus to be paid to employees, based on cost savings resulting from increases in productivity.

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[14] Fred G. Lesieur and Elbridge S. Puckett, "The Scanlon Plan Has Proved Itself," Harvard Business Review, 47:5, September-October 1969, pp. 109-118.

The philosophy of cooperation is central to the plan. All employees participate, up to the top management person in the plant. This is in accordance with Scanlon's desire to have all employees working together and to avoid setting each worker against the others. An individual incentive plan, Scanlon said, put the workers in business for themselves and against the company. In the Scanlon Plan, the mechanism for cooperation is departmental production committees made up of both employees and management. The committees meet regularly to discuss suggestions for improvements, but management reserves the right to decide whether or not to implement them.

The bonus is usually measured in the following way.[15] Basic labor costs are determined so that a ratio of labor costs to sales value of products produced is obtained:

$$\text{Basic ratio} = \frac{\text{total personnel costs}}{\text{sales + inventory changes}}$$

This ratio is set by recent experience. Then if the plant beats this basic ratio (i.e., gets a lower ratio), there is a pool of "cost savings," which is divided between the company and the workers. For example, if the basic ratio of a company is 60%, and in a given month the company's actual ratio is 56%, then there is a pool equal to 4% of sales (net of inventory change) available for distribution. Employees usually divide their portion of the bonus in proportion to their regular earnings from the company.

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[15] National Commission on Productivity and Work Quality, A Plant-wide Productivity Plan in Action: Three Years of Experience with the Scanlon Plan (Washington, DC: U.S. Government Printing Office, 1975).

The plan therefore provides an incentive to the company and all its employees to improve productivity, reduce costs, and generate a surplus to be used as a bonus. Periodically, of course, the bonus must be revised in light of experience.

A number of companies use the Scanlon plan, but many do not. If it is such a good idea, one might think, why hasn't it been more widely adopted? Perhaps the major reason is that to be successful the plan requires a degree of care and attention to productivity that is supposed to characterize American management and labor, but often does not. The plan requires a greater effort and more continued attention than most companies or unions will give to it. But it is surely one of the most sophisticated and interesting programs in American industry.[16]

Objections

The new system is labor-management relations calls for improvements in productivity via cooperation between management and labor, enriched jobs, fewer supervisors, and gain-sharing. The evidence that such systems enhance productivity is on a company-by-company basis, but is persuasive to most people who have studied it carefully.

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[16] See Carl Frost, John H. Wakeley, and Robert A. Ruth, The Scanlon Plan for Organization Development: Identity, Participation and Equity (East Lansing, MI: The Michigan State University Press, 1974). Also, Henry Tracy, "Scanlon Plans: Leading Edge of Labor-Management Cooperation," World of Work Report, 2:3, March 1977, pp. 25ff.

But there is resistance to the system from both management and labor. Managers fear loss of control to employees and unions. Union leaders fear "the end of the labor movement as I've known it," to quote Victor Reuther in a September 1985 speech regarding the UAW contract for the Saturn Corporation.

The new system is not dominant in American industry today. It may not become dominant. What stands in the way is not only a fear of the unknown, but the way many American managers, workers and trade union officials think about productivity.

A Reversal of Roles

Far more important than any particular prescription for improving productivity or any specific program that may be set forth is how our nations' people, both management and labor, think about the issues.

Deep in the thinking of many people in both management and labor is the conviction that improving productivity means cutting the number of jobs. Managers seek to increase productivity by reducing the number of people employed to perform certain tasks. It is not at all uncommon for American managers to prepare reports justifying proposed capital investments by citing the number of jobs which the desired investment will make redundant. Such reports commonly slip into the hands of employees and union officials and reinforce their suspicion that productivity improvements are meant to be at their cost.

Unions and union members often view improvements in productivity as primarily having the consequence of reducing the number of jobs available to working people. And although the matter has not been studied carefully for many years, there is evidence that nonunion employees also restrict output by various devices in the interests of maintaining their jobs.

Yet the highly competitive economy of recent years has also demonstrated that a firm which does not match its competitors by improving the efficiency of production and thereby improving productivity is likely to fall behind in the marketplace and to lose sales, market-share, and ultimately employment levels to its competitors.

Thus it is that productivity shows itself in todays' economy to be both the friend and enemy of employment.

These two influences have been in existence since the industrial revolution began. But the specific nature of the economic context determines which of the two is more significant at any given point in time. Possibly the conviction that on balance productivity improvements were job destroying in industrial companies was the most accurate description of the American economy until recent years. The conviction was appropriate to the days in which our vast internal market was isolated from foreign competition. In this situation the company and the union were free to battle over the division of the returns from enterprise without undue concern that the business upon which both depended would thereby be imperiled.

Today that is no longer the case. Even in automobile manufacturing where recent sales levels are at an all-time high, imports continue to take an increasing share of the market, and no American producer can be certain that it would survive another prolonged market downturn.

Today productivity is more certainly than ever before in our history the ultimate guarantor of the jobs of most of the people who make their livelihoods in American manufacturing. Many managers and union officials have come to recognize this. But not at all. Some companies continue to think about productivity as a process whose purpose is to destroy jobs, and thereby force unions and workers to resist the process. In other instances, union officials and workers continue to see only the short-term danger of job loss in productivity increases, and do not see that unless productivity improves, the jobs of many more people are at stake. To many of our people, productivity remains a threat, not an opportunity. And many managers continue to reinforce that conviction by their attitudes and behavior.

The contribution which labor-management relations can make to American productivity begins at this basic level.

Perhaps the time has come for management and unions in American manufacturing to consider reversing their roles. The unions need to assume considerable responsibility for improving productivity and quality. In turn, management should accept responsibility for providing a greater degree of security for employees.

Traditionally in our country unions press for job security, leaving to management unilateral responsibility for productive efficiency. In many instances unions oppose increased productivity, sometimes on the grounds that it will cause employees to lose jobs.

For their part most companies instead of protecting the security of employees are quick to reduce work forces in order to gain efficiency via automation or the shifting of production to lower labor cost areas.

Today this traditional division of responsibility between management and labor is not working well for either. The unions are not very good at providing security for workers. Rarely do unions in the private sector receive from companies commitments to protect or preserve employees' jobs. At best the unions determine who will get laid off, ordinarily attempting to preserve the most senior workers from lay-off. While this is an achievement of sorts, it does not protect the younger worker, women or minorities, who were often and only recently hired. Nor do seniority clauses protect longer-service employees when a facility is closed and the entire work force is made redundant.

The companies are not as effective at productivity and quality improvements as might be thought. Where the union and a unionized work force are sullen and uncooperative so that management must attempt to bludgeon an unwilling work force into greater effort, little is accomplished. Automation seems to many managements the only alternative, despite its high cost and sometimes questionable pay-off.

In today's world of intense international competition, the result is that many American companies are too inefficient to be competitive. Hence substantial job losses in manufacturing are continuing despite almost three years of economic-recovery from the recession.

The traditional division of responsibility leaves both unions and management in undesirable public postures. Management has the public responsibility for efficiency, but sees the country's manufacturing competitiveness eroding rapidly. Is management failing the country? The unions have public responsibility for job security, but watch manufacturing jobs declining at a rapid rate. Are unions failing the American worker? The question is fairly asked of both.

The answer is that both management and labor can make a greater contribution to American competitiveness. Management can do far more for job security than can the unions. By careful planning and by training and relocation of employees management can preserve the jobs of many people who would otherwise be let go. But it must be noted that often it is not security in an individual's present job that can be provided, but rather security in his or her employment with the company. This is a crucial distinction in an age of rapid technological and market-based dislocations.

IBM in a series of advertisements has pointed out that retraining and relocation are crucial to employment security. IBM has done a remarkable job of avoiding layoffs of its full-time employees in an industry which we now recognize as having significant ups and downs. IBM is nonunion. Why cannot unions and unionized employers do as much to provide employment security?

Unions are able to make a much greater contribution to productivity than they have done. Productivity is as much a consequence of working smart—of attention to the job and commitment to the enterprise—as it is of working harder. Unions can contribute to a change of attitude among their members. They can encourage productivity and quality.

Representing workers with grievances remains an important function for unions, but one which is best pursued in a problem-solving fashion rather than a negotiating or confrontational mode. Management has to be prepared to respond in the same spirit. There is evidence that both sides are more willing to do this today than in the past. Too often in American labor relations disputes over grievances or over contract terms escalate into open hostility, including strikes or slowdowns, imperiling a business and the jobs of the union's members. It is the sign of an immature relationship that each matter of disagreement tends to escalate into an all-out battle that threatens the viability of both sides. In this sense, American labor relations appear immature and self-defeating compared to those in certain of our key international competitors, particularly Japan and northern Europe.

To call for a reversal of roles between union and management on the key matters of productivity and employment security is not merely to whistle in the wind. There are trends in this direction. Recognizing the need to be competitive if jobs are to be saved many union leaders are saying quietly to management about the work force, "you get them to work; we won't object."

But this is not enough; nor is it entirely proper. In reality management cannot compel people to work smarter and better, even if it can drive them to work harder. The unions have a more affirmative role in increasing productivity.

But the unions know that enhanced employment security will not emerge from greater productivity automatically. Management must make the effort to plan for the productive employment of today's workers and retrain them for skills and work practices needed in a changing economy.

Hence, the need for a reversal of roles. Unions can do more today for productivity than companies can. And management can do more than labor for employment security. If each will assume a new responsibility, American productivity, employment security and competitiveness can all be enhanced.

Mr. **Dale**. Thank you very much, Quinn.

Let me remind the audience that the method for addressing questions for the panel is in writing and if you raise your hand members of the staff will come around with bits of paper to write the questions on and will collect them.

Our last panelist is Sheldon Weinig, who is chairman of Materials Research Corp., a company well known for its innovative labor-management practices.

PRESENTATION OF SHELDON WEINIG

Mr. **Weinig**. Thank you. As Felix Rohatyn said at lunch, I come from the real world and it's fascinating to listen to all these cosmic explanations of how to increase productivity, but I'd like to invite you all down into the trenches. I think that's one level below yours, at the enterprise level referred to by Professor Mills.

When I look at the human dimension of productivity, the first thing that I look at is the workforce and I'd like to think that the traditional workforce of yesterday whose main focus was pay, who rarely intellectually challenged management, has now been replaced by a workforce that is nondocile, is individualistic, provocative, and it's made up of a total body of mixed gender, mixed language, and mixed work objectives. And when you look at this workforce, the quick fix of emulating the Japanese has to be quickly discarded and those that have tried it, I can assure you, have begun to discard it.

The concept of heterogenity in our society is not second order; it's first order. Let me tell you an anecdote about this phenomenon. I have a factory in the south of Japan, not too far from a major U.S. semiconductor manufacturer. We supply the materials and equipment to manufacture semiconductors. I asked the American vice president of this company how come the efficiency in Hiji, Japan, was so much greater than the efficiencies in Dallas and Houston. His answer was,

> Well, just think of it, Shelley, in Hiji we have 400 housewives, they're all Japanese, and we tell them, you cannot wear any makeup because the most serious damage to a semiconductor is from the particles coming off the face, the human skin, and of course this is exacerbated by the makeup. We don't want you to smoke for 1 hour prior to coming to work because particulate is still coming out of your lungs and therefore it's going to land on the semiconductor and, for God's sake, if you have a salami sandwich for lunch be sure to wash your hands.

[Now they don't have salami in Japan but the concept is the same.]

> Now let's go to Houston. We have a work force there that's 32 percent black, 14 percent Hispanic, 8 percent green, 9 percent yellow, et cetera, and can you conceive of us telling this work force don't smoke for 1 hour prior to coming to work, ladies, we don't want any makeup on you today; and you can quickly understand why the difference in yields is about 20 percent.

This is real world. This is what we have in our society. Let me just take you one step further. In Korea now, online in the manufacture of semiconductors, people breathe into bags. They have a full face mask and they breathe into a bag that they carry around. Further, they are advised not to go to the bathroom during the entire morning shift because just going out and coming back into the clean room brings particulate and these are the destroyers of the semiconductor devices.

Well, short of calling them astronauts, you'll have one devil of a time getting U.S. workers to breathe in a bag all day, let alone deny them coffee or restroom breaks.

So you can see that this heterogenity and independence of the U.S. worker is a real fact of life. We've got to face it and we've got to utilize it in developing greater productivity in the United States.

Second, I suspect that corporate America has already learned that it can be invented there, despite our silent hope and I believe the Congressman mentioned it before, this idea that we have a birthright for the dominance of technological innovation is not true. We have seen this now and we are again faced with reality.

What really concerns me is that we may be giving up on it being invented here and that's the more despairing aspect of this phenomenon.

I still believe in the innovative ability of our society and I suppose if I were 20 years younger and a venture capitalist I would set up an operation that would innovate in the United States, engineer in Japan, produce in Korea, and sell like hell throughout the world. I suspect I would then be a dominant player in the overall game.

Now let's look at the human element in productivity. None other than Dr. Eric Block, formerly of IBM and now head of the National Science Foundation, recently made the observation that the new computerized productivity is going to truly enrich everyone in our workforce—the scientist, the engineer, the technician, the worker—and instead of their essentially operating the machines, they're going to control their environment, control machines and control the operation. The factory process will be the dominent fact rather than the product. What that means is greater flexibility. This is going to require a much greater investment in the human being through education and training—and here's the critical line—universal continuing employment could well be the result of this type of productivity revolution.

However, contrary to this, of course, we have the layoff system of the United States. I don't know if you're aware of it, but it's the only country in the world where layoffs are indiscriminately practiced. Layoffs without recompense are not practices in the free world anyplace else. They're certainly not practiced in Europe. They're certainly not practiced in Japan, but they are a dominant part of our industrial practice in the United States.

We heard this morning that 7 percent of our college graduates are engineers, wheras France and Germany has a 40-percent graduating class of engineers. Yet despite these figures, in the last 12 months thousands of engineers have been laid off in the United States as a result of the downturn in the electronics industry.

So it's very hard to look at these people now and say we want to be committed, dedicated, high-productivity workers. What we're doing here is essentially soiling the nest; we're making it impossible for these people to truly commit themselves to what they're doing.

Well, I agree with Dr. Block's view of course, coming from a former IBM employee, it is not surprising. They are a no-layoff company but I have also run a no-layoff company for 25 years. Don't think this permits me any glory because Wall Street has torn my rear off on a regular basis as to what right I had to use stockholders' money to sustain this employment concept of no layoffs. And If you want to take that one step further, last week in Fortune magazine they had the list of most admired companies, and I quote this line, "Once again, profits provided the surest way to admiration." One quickly realizes that this country is not quite ready for all these wonderful things I've heard my associates speak about today. For example, we mustn't concentrate on profit, we must concentrate on investment, we must concentrate on the human element; we are really a long way from that viewpoint in the United States.

Let's talk briefly about the employment security. I believe that employment security is an absolute necessity if we're going to have leadership in this country in productivity, technology, or innovation. But a no-layoff policy is not a singular phenomenon. It's one part of a total mangement fabric.

For example, if my company hires someone, they are going to be with me for life. Therefore, I'd better worry that they don't become old, tired, and knowledge-deficient before their time. Therefore, I have to have an education policy to go with employment security. The education policy is the best in the world. I recommend that all companies adopt it because it will save you a lot of time, work, and money. It's four words: "You pass, I pay." I've had this policy for 20 years and I can assure you nobody takes advantage of you. If anything, my employees don't take sufficient advantage of the policy. My engineers can take French cooking, engineering courses, or English literature. The argument always is, how can you permit that using the stockholder's dollars? Well it isn't easy to justify. However, companies build gyms to exercise their employees' bodies. I just build a gym to exercise their minds. And you know what? I think I'll ultimately make more dollars out of their minds that I will out of their bodies.

The next thread of the fabric concerns wages. As soon as things get bad, every chief executive says, "We're going to have a wage freeze." This is the dumbest thing in the world. I know, I've done it for years. This last year is the first time I understood the error. Using the carrot and stick analogy—the minute things get tough, beat them more. Rather, we should put away the stick and take our a larger carrot. Continue wage increases during difficult times, but not on an automatic basis whereby if you come to work and breathe regularly you get an increase. Instead, you earn it through superb effort.

How does one effectively do these things? Well, Warren Bennett of the University of California wrote a book called "Leaders" and in this he noted that, "We always talk about managers in business and leaders in government." Well, I think that is backwards. We need leaders in business and managers in government. In fact, we should have all MBA's work in government.

Well, I see the red light looking me in the eye. In conclusion, why practice these types of management policies? We want a committed employee. Some pundit recently said, "commitment means high productivity, low turnover, and a better chance of avoiding corporate death at the hands of the Japanese." Well, I can't find anything to disagree with there. Thank you.

Mr. **Dale**. Thank you very much. [Applause.]

Let me remind you again that questions are welcome. We have a good 15 minutes in which to receive and answer them and if you raise your hand the staff will be there with a card.

Let me begin with the first to Quinn Mills. You had this intriguing notion of a shift in roles in which the union would be the supplier as it were or the fosterer of productivity if the mangement would be the fosterer of job security.

In what sense do you mean? A straight never, never, never layoff policy or what?

Mr. **Mills**. I don't think anyone seriously believes that a company can guarantee no layoffs ever under any circumstances and I think that doesn't even occur abroad and in fact there are layoffs.

Mr. **Dale**. There certainly are in Britain.

Mr. **Mills**. Certainly and there are in France and Japan, too. It is not a common and quick recourse as it is in the United States. IMB's policy—IBM has policies and it has practices. Full employment, by which they mean no layoff, is a practice. They have done it for 40 years, but they don't guarantee it for their employees because it depends upon performance. It's in that context that I think it would be proper for much of American management to assume more responsibility for the job security.

I mean by that particularly, if you'll grant me 1 more minute, it's very important to make a distinction between employment security and job security. It is inappropriate for employees and unions to ask for security of people in the jobs that they have. They have got to be prepared to be retrained and relocated if necessary as economic conditions change.

Employment security is possible.

Mr. **Dale**. As distinct from the security of the individual job?

Mr. **Mills**. In a particular job, yes.

Mr. **Dale**. Now a question—I think I will address this one to John Kendrick. This discussion seems to refer, not yours particularly, mostly to goods production and the word "plant" keeps cropping up all the time, and yet something like 70 percent of all American workers are not in goods production at all but in services of various kinds. What is happening to productivity in the service sector?

Mr. **Kendrick**. Well, we have measured for both because you can count the numbers of services of particular type rendered, the number of haircuts, appendectomies, bank clearings, and so forth. Our measures are not quite as good in the service areas as embodies in the real gross national product, but they do show that productivity in services has risen a bit more than half as much as in goods, something like 1.7 percent versus about 3 percent in manufacturing and goods production.

Mr. **Dale**. Over what period?

Mr. **Kendrick**. This is looking at it since 1948 or so, the long-run trends. The opportunities are great in services as well as in goods. Electronic data processing and various kinds of office equipment, word processors, and so forth have helped a great deal in service industries, of course, in finance and in all industries, of course, we have office work where they help. Some of our service industries have done extremely well if you include telecommunications as a service industry. There we've got among the highest rates of growth in the economy of 5 or 6 percent a year.

So I think that whereas we are shifting gradually to services, that there is the opportunity at least to continue the past trend rate and even perhaps to accelerate as we try to apply technological advance to services.

Mr. DALE. The question reads: do we need another Employment Act with emphasis this time on job security and plans such as ESOP's to encourage worker productivity as well as education for employees? Well, I don't know whether we'll put the question necessarily as needing an Employment Act but I would like any of you who wants to volunteer, perhaps starting with Ray Marshall, to discuss what we know about the worker ownership results in such areas as ESOP's.

Mr. MARSHALL. Well, I think the evidence—while the movement is still pretty new—is nevertheless fairly clear that ESOP's greatly improve productivity and profitability. Therefore, I think the ESOP is a good thing and we ought to encourage it.

I would say if we were going to pay attention to a new Employment Act, what I would do would be to give a heavier emphasis to the quality of jobs as well as the number. We've done a pretty good job in this country creating numbers of jobs, but our real wages have declined, ESOP's are one way to make it possible for workers to have nonwage income so it has that advantage. And I must say, so would a bonus system which I favor and believe that would introduce an element of flexibility.

The thing that none of us mentioned that is terribly important in all of this is the importance of an incentive system in improving productivity. I'm struck by the fact that the Japanese workers, for example, have a much stronger belief that improving productivity will improve their personal welfare than is the case in the United States.

Public Agenda did a study I think in 1983 and they found that 93 percent of Japanese workers saw some connection between improved productivity and improving their own personal welfare; 9 percent of American workers saw such connection. Now ESOP is one kind of incentive system.

Mr. DALE. I've got an intriguing question here for Sheldon Weinig. It's straightforward and concise. Are you suggesting that MBA's inhibit productivity growth? If so, how and why?

Mr. WEINIG. That's a very difficult question to answer. Really I'm not sure how to answer it. I would like to use the opportunity, however, to speak to another point just very briefly. [Laughter.]

I think it's a very important point—I'd like to latch onto Ray's remarks—about the incentives used by the Japanese.

In our Japanese plant, the contractual incentive arrangement is a minimum of about 1 month's bonus for 6 months of work. So in a year you're giving away 2 months per 12 or roughly one-sixth or 16 percent.

If you look at companies in the United States that have bonus programs or some form of profit sharing, you generally find it's 1 or 2 weeks per year and you just don't have enough muscle in 2 weeks to pay to really get their attention. That's why your disparate numbers. I hope that answers the other question.

Mr. DALE. I think this is an intriguing question for Dr. Mills. Even if we concede your point that the employer should play the lead role in providing employment security, do you think Government has any role to play in job security in the private sector.

Mr. MILLS. As a general rule, I am suspicious of Government intervention in these things. I'll make a few sentences of comment.

There is in the current edition of the American Economic Review an article entitled, "The Simple Macroeconomics of Profit Sharing," of gain-sharing, and I think the article is well named. It is a relatively simple set of macroeconomic considerations and they appear to me to be quite favorable.

The microeconomics of gain-sharing and profit sharing are really quite complex. It reminds me of the simple macroeconomics of wage and price controls. Whereas the microeconomics of that are extremely complex and our attempts at the national level to pursue the simple macroeconomics to their logical and successful conclusions have been stymied time and time again by the complex microeconomics. I think the same thing tends to happen in the area of gains-sharing and employment security. If there is to be legislation, it ought to be legislation that is enabling, that enables companies and unions to do what is appropriate in their individual situation.

Mr. DALE. Just one quick followup on that—enabling them to what that they can't do now? Why do we need any legislation at all?

Mr. MILLS. In the employment security area. One thing that occurs to me is that an awful lot of employment security has to do with the movement of people physically, geographic relocation, and also the continual reeducation and retraining of people. It is perfectly possible for our tax laws to encourage that considerably more than they do now, considerably more—both of those.

Mr. DALE. This question is relevant really for both you two at the other end. Mr. Weinig's testimony implies—and I think Mr. Mills may have agreed—that to generalize no layoff policies it may be necessary to change the way private companies are financed, for example, increasing the share of patient investors in the ownership of companies with longer term horizons. What would your comment be on that and is there anything anybody can do to bring it about?

Mr. WEINIG. Well, I would have to agree completely on the fact that you do need patient investors. As I indicated earlier, we've had our share of impatient investors.

I think the other thing, having gone through lots of business recessions, whether they were man made or not, is that you become more adept at working in down environment with a no layoff policy and it isn't quite as devastating as people might think. First of all, you run your business entirely differently. You run a very tight ship. I believe that Professor Mills remarked on the point of flexibility—an absolute necessity. On the first day of employment at our company employees go to a 1-hour lecture on employment security. They are literally taught contract law, that is, that the consideration for employment security is a commitment to flexibility which means you will work in whatever plant, whatever shift, and at whatever job we perceive as necessary during a difficult period. We even use KP or kitchen police, as we all recall from the military, in which people are put on maintenance, garden and lawn work or cleaning johns so to speak for defined periods of time, and that contract is made up front. In 25 years, I've had only one person say, "I will not accept the assignment, but you must be very careful in your initial screening of potential employees.

Mr. Dale. May I ask you, is your company itself a cyclical one? Is demand cyclical in your field?

Mr. Weinig. Sir, I supply the electronic industry. They invented cyclicality?

Mr. Dale. OK. Do you have any thoughts on that, Quinn, about the problem of financing and Wall Street telling him anybody who guarantees no layoffs has got rocks in his head?

Mr. Mills. Other than to say that that is consistent with my experience, I have nothing to add. I think he made an excellent statement.

Mr. Kendrick. On the cyclicality, I'd like to say something that related to a couple of comments this morning that our policy makers deliberately brought on recessions since 1958 or 1961. Let me say that I think the answer to that lies in a remark of Herbert Stein's who said that one reason for our economic problems has been we'ver been overly ambitious with respect to the unemployment target and the growth rate.

I think the reason that we have had recessions often is we've gotten overheated in the economy, prices start rising faster than a prudent monetary policy will accommodate, and that has brought on a cost-price squeeze.

I think at the present time we could certainly do better than our long-term growth rate because we have unused resources. I would like to see a growth rate of 4 to 5 percent for a couple of years to bring us down to around at least 6 percent unemployment which I think is about the national rate now below which wage rates and price increases tend to speed up, around 86 percent utilization of capacity. But then once we are down near those threshold rates, then we should pursue a more modest growth policy of 3.5 to 4 percent which I think is our natural sustainable long-run growth, and forget the 4 percent we had back in Leon Keyserling's time and some of the other targets which were really too ambitious.

I think that's something we've learned over the last several decades, that we have to pursue a more moderate growth policy once we get back to relatively full employment.

Mr. Dale. Did you have some thoughts on that, Ray?

Mr. Marshall. I have some different kinds of thoughts, one being that I agree that 6 percent might be the lowest rate you can get to through macroeconomic policies alone, but I think if the problems are structural then we ought to use counterstructural means to achieve lower levels of unemployment rather than simply relying on macroeconomic policies alone.

The second point I would make is that we're in a different kind of world now and the same kinds of economic policies that would have worked even in the 1960's will not work in an internationalized information world. Many of our macroeconomic policies have acquired such leakages that we are unable to achieve as much with economic stimulus alone as we could in a previous time.

But I think that what we have to do is have a much more complicated mix of policies than we have had in the past.

Mr. **Dale**. For John Kendrick, a little elaboration of your suggestion of a focal point in the U.S. Government to deal with the longer-run issues involved in improving productivity, what do you have in mind? Where would it be? The questioner asked a rather micro question associated with this. Would it include such things as the French export credit subsidies to keep employment high? I wouldn't have thought that was what you had in mind.

Mr. **Kendrick**. No. I'm thinking of the whole range of policies that could be grouped under the main causes of productivity advance which I listed earlier. That's very much broader than the policies that were embraced by our National Center on Productivity and Quality of Working Life. All of you know that for 8 years we had national centers from 1970 through 1978. The General Accounting Office gave a somewhat unfavorable review of their performance and I think the reason they were not too effective is that they were focusing more on specific management, labor, consulting-type work.

We now have private sector productivity centers which are doing this. What we need is a center in the Executive Office which pulls together policy options relating to taxation, expenditure, capital spending, to R&D policy, to human investment policy, coordinating from the different agencies and departments for the use of the President in selecting the options which he would wish to propose to Congress and I presume the counterpart in JEC.

It's not explicit in our present Employment Act. Herbert Stein said that growth is not mentioned in the 1946 Employment Act. Nevertheless, I think it would be done under the Employment Act and this focal point could be put in the council with a counterpart review function in the Joint Economic Committee or it might be better as a separate point.

The exact organization setup isn't so important, but I think it is important that we focus as much on the long range as well as on the short range as we now do in Congress and in the executive.

Mr. **Dale**. If I can make a comment, in my experience of 5 years now in the executive branch, it's my impression that in the development of a tax bill or in discussion of an R&D tax credit or other research allocations within the budget, sight is not lost of the long run. An awful lot of thought went into the productivity issue in designing Treasury I and Treasury II and the rest of the tax policy. I would be skeptical that there's something significant missing within the executive branch that another committee should be formed to fill the hole.

Mr. **Kendrick**. Not necessarily a committee, but I think certainly one of the members of the council should focus on that. You're quite right, we do consider the long as well as the short, but I think greater emphasis to that as we're giving in this symposium would be helpful.

Mr. **Dale**. I think it was Professor Mills who pointed in his talk to the short-term profit motive as a significant factor in a chain of events that leads to lower productivity growth, but yet it's been often alleged and I guess it's true that frequently the training in business schools and subsequent management roles of graduates of the Harvard Business School is very much focused on getting short-term profits. Is anything being done to change that kind of emphasis?

Mr. **Mills**. I was thinking earlier when Shelly was asked if MBA's contributed to the productivity slowdown that I would have to give the answer "No." The institution with which I am associated invented the degree and we are still its largest producer, although there are some 50,000 MBA's awarded annually in the United States today and the Harvard Business School has only a 2.5-percent market share.

A candid answer would be that the suggestion that the financial markets to which we send most of our best students today and the MBA's that go to them do have too much of a focus on the short term I think is fair. Do we contribute to that? Without any question. Are we the sole contributor to that? No. Did we develop the theories that have now become so common and which are in our curriculum as well as in other people's curriculum? The answer is "no." They were developed in Chicago and MIT for the most part. [Laughter.]

Lastly , are we trying to do something about it? We lean as hard against that wind as we can. But while we contribute to the American economy we really don't have the kind of influence that would suggest that we are a major mover in that area.

Mr. **Dale**. Good answer. Ray Marshall.

Mr. **Marshall**. Well, it seems to me that this goes back to the previous question about financing. Reginald Jones, former chairman of the board of GE, once said that one of the main problems forcing this short-run perspective of American managers was the tyranny of Wall Street he called it. It's the system; if you are chief executive officer of a major corporation that depends upon Wall Street for financing, you've got to take a short perspective because, as Felix Rohatyn mentioned, you've got these people who are afflicted with the short fling and they will sell you out in a hurry if you show an unfavorable profit-loss statement, income statement, in a short time.

Therefore, it seems to me that is a very important issue when you consider, for example, the extent to which institutional investors are doing the investment on Wall Street and that what one chief executive officer said to me not too long ago, "If you were in my position, you would do exactly the way I am, even though I agree that what I'm doing is ruining the company."

Mr. **Dale**. It's a very troublesome fact and I'm darned if I can figure out any way to do anything about it as long as it's a free market out there and the institutional investors run in herds on short-term earnings statements, and I'm afraid we will have to leave to some other panel the solution for that conundrum.

I would like to thank all of our panelists and you all for some excellent questions and we will now adjourn this session. [Applause.]

Chairman **Obey**. Thank you, Ed, very much.

[Recess.]

Chairman Obey. If I could have your attention, please, we would like to resume with the last panel of the day. I would ask the panelists to come up and we will start.

This symposium is about the kinds of public economics we need to effectively meet the challenges of the next two decades. To me, there is no greater challenge than finding an appropriate fit between the way we run our economic system and the basic values of our own society and culture.

The first obligation of an economic system is obviously to work, but economics is fundamentally about people. It is concerned with how to satisfy the expectations of people for material goods and for fulfilling roles in economic life.

In this sense, economics is as much about sociology or philosphy or psychology and religion as it is about mathematics and statistics.

A successful economic system must satisfy the material wants of its citizens, but material success alone is not enough. An economic system must also meet the test of values. To survive and flourish an economic system, at least in my judgment, needs to be organized in a way which makes sense to people and satisfies their moral sense about what's right and fair.

In recent years we have appeared to come to accept the notion that we run our private lives along one set of values but our economic lives along another. In our homes, families, and communities, we value the virtures of toleration, cooperation, compassion for others, and sharing. In our economic system we seem to reward competition, self-interest, individualism, and devil-take-the-hindmost attitude to those to whom competition leaves behind.

Voices have been raised among us to ask us to rethink these priorities. Chief among them has been the voice of the U.S. Catholic Bishops whose recent pastoral letter drafted by Archbishop Rembert Weakland and others calls upon us to produce an economy which better reflects the values by which we live in our families and communities.

As we approach the question of creating an economic system which does reflect American values, we confront an ancient dilemma: the possibility that traditional Judeo-Christian values do not work as well as we would like to think as an organizing principle for a modern economy. It was Keynes who expresed the dilemma clearly when he noted that to his regret in the organization of economic life foul was useful and fair was not.

It is the challenge of this next panel to explore how we can match the realities of market forces with the values of our society and the moral requirements of our Judeo-Christian heritage. In short, how do we make a manmade economic system work in ways that serve a higher purpose?

I think there are probably two tests of economic policy, along with everything else that we do, and they occur at different times. The first test is the day-to-day current test of whether or not what we do works, and the second test when we pass into the next life is are you proud, are you satisfied of how you made it work? And I think we have to ask both of those questions.

We have with us today to serve as the moderator for this next panel Mr. Bill Niekirk, who's a veteran Washington news reporter of the Chicago Tribune, whose most recent writings have emphasized economic shift between generations and disparities in family income. Bill, I thank you for being here.

PANEL: CREATING AN ECONOMIC SYSTEM WHICH REFLECTS AMERICAN VALUES—BILL NIEKIRK, MODERATOR

Mr. **Niekirk**. Thank you very much, Mr. Chairman.

I asked two of our reporters in the office—I shouldn't say reporters—one a reporter and one an editor, and for the journalists here they will know there's a significant difference in what I'm talking about—about what do we mean by American values, just sort of to introduce this panel.

From the Supreme Court reporter, I got, "Family, home, freedom, conscience and freedom of religion, equality before the law, protection of minority rights, the right to work, the right to push your fortune wherever you think it's best for yourself, and the right to work and to participate in Government."

From the crusty old editor I got, "Possessions, financial security"—if you're an editor you need financial security, believe me—"me, me, me, and greed."

So I think you will see the challenge facing this panel here today and I don't think your moderator will have to intervene too much. I want to remind you at the very beginning as you've heard before, if you have a question from the audience, simply raise your hand and one of the staff will get you a piece of paper and they will be collected and brought up here. I will remind you again of that while the panelists are speaking in the interim.

Our first speaker for the panel is Mr. Daniel Yankelovich, who's president of the survey research firm of Yankelovich, Skelly & White.

PRESENTATION OF DANIEL YANKELOVICH

Mr. **Yankelovich**. Thank you.

The handout describing this symposium makes the statement that over the past several years there has been a growing awareness that the economy is undergoing a new transition. I think that is true. It is also true that the political life of the country is at the very beginning of an important transition. Let me first state what I think is not happening.

From all the data that we can glean there does not appear to be an erosion of values. That is to say, there is no evidence that there has been a significant decline among the baby boom generation of caring and compassion or that the emphasis on self and pleasure have eroded the work ethic in any significant way. The decline of the quality of life in America in terms of values does not seem to be what this transition is all about.

Also contrary to a great deal of discussion and debate, there is no evidence to suggest that it constitutes a shift to the right in any ideological sense. There remains in the country massive support for moderate centrist programs such as health and education, to help people who can't help themselves, and to provide social insurance of various kinds for average middle-class citizens.

What it does appear to be, it seems to me, is a growing suspicion, strengthened by the point of view of the Reagan administration, that many of our Government programs do not keep faith with our most cherished values and that therefore they deserve fundamental reappraisal. That means a shift away from national government programs of the entitlement transfer payment type to more initiative by local communities, individuals, and the like.

In my brief introductory remarks, let me simply name some six basic values that I believe are the dynamic force in shaping today's political climate and through it, the economic climate.

First and foremost, transcending all others, is the American passion for individual freedom. In every survey, this value stands above all others and many of the other values derive from it. One of them is directly relevant to the economy: a concern that there be opportunity for individual effort to pay off, for freedom to lead through work and effort—to rewards; hence, an immense emphasis on equality of opportunity. The notion that anybody who works hard can get ahead is still the dominant viewpoint of the American public. To some extent, an inequality of result attests to the presence of individual freedom.

Consequently, there is a widespread rejection of income limits. The dominant feeling on the part of average Americans is that they do not want to have their potential income being limited.

Third, is the value of autonomy, the strong desire to stand on one's own two feet, alongside of the recognition that it is not always possible to do so. This turns out to be a very important factor in leading to certain kinds of legislation.

Fourth, there is an enormous emphasis on the value of reciprocity, the idea that you should give something back for what you get and that there is an implied giving-getting contract. This means deserving is as important, if not more important, than need, and that getting something for nothing violates fairness.

Fourth, is a continued strong—even stronger than in earlier years—emphasis on competitiveness—the will to win.

Fifth, is a growing emphasis on the value of community, of compassion and of concern for those who can't help themselves, but in a somewhat different context than the presumption of Government programs of the past.

Now, what I would call the old logic that supported the welfare state is something like this: "I want to stand on my own two feet, but I am limited by the amount of personal control I have over the various areas of my life."

The Council on Life Insurance has been doing studies since the mid-1960's on where Americans feel they have control over their lives and there is a very dramatic pattern from the mid-1960's to the mid-1980's showing a feeling of erosion of control over such areas as (1) providing for children's education, from 63 percent to 25 percent; buying your own home, 69 percent to 35 percent; and accumulating funds for retirement, 58 percent to 28 percent.

There aren't the same systematic data, but I would say that concern with not having control over one's job is a new and fundamental area where feeling loss of control becomes extremely important. As soon as people experience a loss of control, they are receptive to help from others, and in the past have turned to Government for that help. That has been the dynamic and the logic.

The old logic is still very strong. The majority still feels that the Government has a basic responsibility to take care of people who can't take care of themselves. However, there is increasing awareness of Government costs and affordability reflected in the awareness of budget deficits. There is a dawning recognition that some Government programs that are supposedly based on social insurance, such as Medicare, really are not. But mainly, the new logic that will become stronger in the future, has to do with whether or not existing Government programs meet these six values, and a growing suspicion that they do not.

In other words, it isn't the values that have changed. What has changed is the appraisal of Government against these values as criteria, and a sense that many of the programs violate personal freedom in the sense of Government interference, violate reward for effort, violate standing on one's own two feet, reciprocity, competitiveness, and community.

It is the dynamic behind this transition that I believe is what will make it grow stronger. In other words, this process shows itself in the form of increasing resentment on the part of Americans about some of the contradictions that Government programs run into when one person's needs come in conflict with another person's effort and sense of deserving.

As a result, in those areas where people feel they don't have control but need help, there is a growing tendency to look not to the National Government but to find new solutions at the individual level, and at the local and State level as distinct form the national level.

My time is up.

Mr. **Niekirk**. Thank you very much, Mr. Yankelovich.

Our next speaker is Archbishop Rembert Weakland, who is Archbishop of Milwaukee and chairman of the drafting committee for the U.S. Catholic Bishops' Pastoral Letter on the Economy.

PRESENTATION OF REMBERT G. WEAKLAND

Mr. **Weakland**. Thanks, Bill.

We feel as bishops that an important part of the debate today, the economic debate, is not just the technical issues but also the question of moral decisions. Our Catholic tradition accepts without any difficulty the value of technical competency and empirical accuracy and especially in public policy, but at the same time, we feel that moral judgments are involved.

Behind the maze of statistics, the rise and the fall of economic indicators that we receive so often, lie human lives, individual tragedies, and individual successes; and behind the charts that we read so often are real neighborhoods, families that are deeply affected by the social consequences of economic decisionmaking; and it's because these economic decisions affect people and the lives of people that we consider them moral, that they are moral decisions as well.

So the formulation and implementation of economic policies, we feel, cannot be left just to technicians, special interest groups, or market forces. They do involve a discussion of the ethical values involved.

I would say that the basic criterion in our entire letter, the value, if you will, is the value of the human person. Perhaps all these others can be subsumed under that one value. What counts to us is people and how an economic system affects people and it cannot be, according to our mode of thinking, the other way around.

That's why we begin immediately by asking the question: What does the economy do for people? What does it do to people? And how can people participate in it? This becomes the general overall value that goes through our entire letter.

I would say it's only because we are interested in people and the quality of their lives as a church that we have a right to enter into this kind of debate.

At first, a principle or a value such as human dignity might seem to be far too vague. Yet it seems to me that the battle that we are fighting here in the United States—that we've always been fighting—against slavery, this is a battle of human dignity. The battles during the industrial revolution so that our neighbors would have any kind of just wage and also a place to work that would be sane, that's question of human dignity. We feel that assisting workers in plant closings, and all the human costs involved in that dynamic move of our economy today, is a question of human dignity. And I can tell you from very practical experience, standing beside farmers as they lose their land and their heritage, that is indeed a question of human dignity.

That theme of human dignity, that value, the importance of every person on this globe—by the way, we say that this importance of every person on this globe does not depend on race, nationality, sex, or even one's accomplishments or what one inherits—comes from the creative act of the Lord Himself.

We spell out that question of human dignity in various areas and I would just like to name a few of them.

The first is that we feel that human dignity cannot be fulfilled unless we have a stronger sense today of what it means to live in community, what it means to be member of society. Because of that, we place a strong emphasis in our document on what a community should be like, the needs that people fulfill in community and their right to participate in community. This is why we place such a strong emphasis on the need for employment.

One can make the statistic, fine, we can't get below 6 percent. That can be said. But when you say that, you have to say what happens then to the 8 million who do not have a job and those who depend on them? That is the human question that cannot be left just hanging in the air.

For this reason also, we talk a bit about marginalization, those who have no voice, no choices in the social, economic, and political structures of our society, and we find this kind of poverty is a blemish on our society and one that we must continue to deal with—those who have been cut off from the American dream, the American mainstream.

In this regard, our pastoral letter offers a very strong challenge stating that basic justice demands the establishment of minimum levels of participation for all peoples in society and we talk there about the whole question of economic rights. This has been brought up so frequently in Catholic social teaching, most recently by our present Pope when he addressed the United Nations, and we feel it's time for us to flesh out that concept just as we fleshed out the concept of political rights at the beginning.

In this context of participation in society, we talk then about our preferential option for the poor. This is almost saying the same thing but the other way around: from our Biblical tradition and from our tradition of social teaching, there is a weighted concern for the poor. We do not see this as an either-or proposition but simply that those who are powerless must have help. We use the term "option for the poor." Perhaps it's not the best. It has been borrowed from current literature, but still it gives the sense that we judge a system by how everyone is participating and this means in a very special way that the poorest of the poor are able to take advantage of the system.

I feel that this is the kind of issue that we in church can bring up, one of those mediating structures in society, because we have firsthand information and firsthand experience in dealing with the poor, the long soup kitchens that we have, those lines which in a city like Milwaukee never seem to end.

I have been in Milwaukee now as archbishop 8 years. Our soup kitchen lines have quadrupled in those 8 years and our lack of shelter has quadrupled in those 8 years. So questions of high unemployment, massive shortage of low-income housing, millions who are going without adequate health care—all of these are issues that affect human dignity and they are issues that we feel must be dealt with.

We are especially concerned about women and children and I think you know the statistics about children. If you are a child today under 6, one out of four lives in poverty and what is that going to mean down the road in terms of their own physical and mental development and ability to participate in the future of society.

Our draft letter does suggest some responses to that question, especially the creation of more employment, self-help efforts among the poor, reforms in our educational system. I think we could say that as a part of our tradition as Catholics we place strong emphasis on the educational system. We also sense the need to bolster some of the great values of society, those that were mentioned by Daniel Yankelovich—family, commitment, and so on.

We say that economic growth in itself will not solve the poverty problem. We need more direct initiatives in both the public and the private sector and for mediating structures such as church to deal adequately with this issue.

One aspect that has not been mentioned so far, yet we feel permeates the whole of our letter, is the question of what we call global dependency. We are at this moment, economically speaking, all of us, tied so closely one into another. Whether the issue is employment, trade policy, monetary policy, virtually any major economic issue, there's an inescapable connection now between our nation's domestic decisionmaking and the rest of the world.

We feel that that kind of value of the whole world, which is a moral interdependency not just economic, must become a part of our values and our consciences. We are developing into a single moral community on a global level and this involves all kinds of concerns. Perhaps that's why we spend so much time dealing with nuclear weapons, that's why we are concerned about ecology, and all those other global values. That's why we also are concerned about these 800 million people around the globe who live in absolute poverty. Again, the principle of human dignity is extended to everyone on this globe and not reduced only to ourselves.

We feel that we can't be true to our religious heritage and be silent on these questions of economic justice. We are trying to find ways and means so that we can keep alive among us this great respect for the human person and the rights of weaker and the poor, and that this is consonant with the finest of the U.S. values and traditions.

Thank you.

[The complete presentation of Archbishop Weakland follows:]

Remarks of

Archbishop Rembert G. Weakland
Archbishop of Milwaukee

Chairman, Committee on Catholic Social Teaching and the U.S. Economy
National Conference of Catholic Bishops

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Joint Economic Committee
United States Congress
June 16, 1986

An important part of public debate over economic policy is the set of values and assumptions that lie behind the technical debate. As a religious leader, therefore, I want to focus attention in my remarks on the ethical content of economic decision making. I will do so in light of the draft pastoral letter on "Catholic Social Teaching and the U. S. Economy," a document that is currently under discussion and will be voted on by all the Catholic bishops in November, 1986.

In pursuing a very public and extensive discussion of the draft pastoral letter, we bishops are attempting not only to educate Catholics about the Church's social teaching, but also to stimulate a public discourse about the ethical dimensions of economic life. We seek to be a catalyst to join the moral and the technical, so as to overcome what is sometimes an excessive fragmentation of the various disciplines in society. We undertake this exercise with the firm conviction that a conscious effort to engage morality with economics will enhance the quality of moral discussion in our society.

Our Catholic tradition recognizes the value of technical competency and empirical accuracy in issues of public policy. These are clear prerequisites for the achievement of just and effective decision making in an arena as complex as our nation's economy. But these are not enough. Moral judgment based on sound values is also an essential element. For behind the maze of statistics and the rise and fall of economic indicators lie human lives and individual tragedies and successes. Behind the charts are real neighborhoods and cities and families deeply affected by the social consequences of economic decision making. It is precisely because these economic decisions ultimately affect human persons that economic issues must also be seen as moral issues — issues that cannot be adequately resolved without considering the human and moral values that are inherently part of them. Therefore, the formulation and implementation of economic policies cannot be left solely to technicians, special interest groups and market forces. It must also involve a discussion of the ethical values and the moral priorities of our nation.

We begin our pastoral letter by saying that any perspective on economic life that is human, moral, and Christian must be shaped by three questions: What does the economy do for people? What does it do to people? How can people participate in the economy? The basis for all of the moral norms presented in the letter is the belief in the dignity — the sacredness — of the human person. In short, the Church is interested in economic issues because the Church is interested in people.

At first, this concept of human dignity may seem vague, but it has many practical applications. Almost all the battles we faced in the U.S.A. to gain civil rights for blacks was a battle for human dignity; all the struggles for decent labor conditions that were carried on at the time of the Industrial Revolution were struggles for human dignity; assisting workers affected by plant closings is a question of human dignity; standing with farmers as they see their life's work and heritage disappear is a question of human dignity.

With that as background let me comment on just four themes that are among those which are addressed in the pastoral letter: a) the social nature of the human person; b) the option for the poor; c) the protection of human rights; and d) interdependence on the global scale.

a. Social nature of the person

Our teaching says that the person is not only sacred, but is also social. This truth today must be reinforced — particularly in our culture and our time, when individualism is frequently taken to extremes. Our tradition recognizes the value of individuality, but it also insists that we are all radically social. We require a social context in which to grow and develop fully. Therefore, the way we organize our society economically, politically, legally and socially has a direct impact on human persons and their dignity.

Many would argue that we in the Church should focus all of our attention on personal and family values and avoid the social issues. They would like us, for example, to do all in our power to preach sound personal and family values to the poor, but not to address the broad social and economic issues that are involved in the issues of poverty. This very limited approach is inadequate in our view, for we believe that values are important at all levels — personal, familial, and social. The search for economic justice must be based on a respect for human dignity at all of these levels, since they are intimately intertwined.

Our concern for the social nature of the person leads us to put a great deal of emphasis on the themes of community and solidarity and on the need for all people to participate fully in decisions that affect their lives. The ultimate injustice is for a person or group to be treated as a non-member of the moral community which is the human race. This is what we describe as "marginalization" — having no voice and no choice in the social, economic, and political structures of the society. The poverty of individuals, families, and communities is evil, therefore, not only because people's material needs are not being adequately met, but also because they are prevented from fully participating in society as active and productive members. They are cut off from the mainstream of American life.

In this regard our pastoral letter offers a strong challenge, stating that basic justice demands the establishment of minimum levels of participation for all persons.

Where people are unable to find work even after searching for many months or where they are thrown out of work by decisions they are powerless to influence, they are effectively marginalized. They are implicitly told by the community: "we don't need your talent, we don't need your initiative, we don't need you." If society acquiesces in this situation when remedial steps could be taken, injustice is being done.

Because work is so important to human dignity and to full participation in society, we say in our letter that full employment is the foundation of a just economy. The most urgent priority for domestic economic policy is the creation of new jobs with adequate pay and decent working conditions. We must make it possible as a nation for every one who is seeking a job to find employment. In our judgment, the nation is not doing all that it could to achieve that goal. Therefore, we call for a combination of policy initiatives that would bring the unemployment rate significantly below the 6 - 7 percent range. These initiatives include broad fiscal and monetary policies as well as more targeted programs in both the private and the public sector.

b. Option for the Poor

In looking at the world the Catholic tradition is concerned about the whole society. But, we say, the Scriptures have taught us to have a weighted concern for the poor. It is not an either-or proposition, but we must give special attention to the poor. This theme, commonly referred to as the "option for the poor," is a basic and consistent one throughout Catholic social teaching. The biblical concept of justice suggests strongly that the justice of a community is measured by how it treats the powerless in society. As pastors, we bishops have seen firsthand the extent of poverty in our land. We have seen the long lines at our soup kitchens and our shelters. We have seen the effects of persistent high unemployment, of the massive shortage of low-income housing and the millions of families who are without adequate health care.

Above all, we have seen the damage poverty has done to children, the age group hardest hit by poverty in our land. If you are a child under the age of six in our nation, your chances of being poor are one in four. And if you are black, your chances are fifty-fifty. Seeing the economy in this way must surely motivate us to fashion a new commitment to eradicate poverty in America. For the children's sake and for our welfare as a society, we simply must do more.

Our draft letter suggests some elements of a national response to poverty — jobs and training for the poor, the promotion of self-help efforts among the poor, a reform of our educational system, substantial reforms in the welfare programs, etc. We don't claim to have all the answers and the technical solutions, but we do insist on the moral imperative to do more to alleviate poverty. It seems clear to us that economic growth in itself will not solve the poverty problem. We need more direct initiatives in both the private and the public sector in order to deal adequately with this issue.

This theme of option for the poor suggests that part of economics is not only how we produce, but how we share. Thus the theme of distributive justice is a major thread running through the pastoral on the economy. We point to the high degree of inequality in our land in terms of the distribution of wealth and income and to the fact that the gap between the rich and the poor is growing. This trend must be reversed if we are to deal adequately with poverty and promote a real sense of community in the nation.

c. Human Rights

In Catholic social teaching this economic minimum which is owed to every person by society is made explicit by a specific set of economic rights — for example, the right to adequate income, the right to employment, food, shelter, medical care, education, etc. These fundamental personal rights form a kind of baseline, a set of minimum conditions for economic justice. They form a bottom line for judging how well economic institutions are protecting human dignity and promoting social solidarity.

Our discussion of these economic rights takes place in a society that understands political rights but questions the very idea of economic rights. Therefore, we call for the formation of a new cultural consensus that all persons really do have rights in the economic sphere and that society has a moral obligation to take the necessary steps to ensure that no one among us is hungry, homeless, unemployed, or otherwise denied what is necessary to live with dignity.

d. Global Interdependence

The interdependence of our nation with the rest of the world is very evident when one examines the American economy. Whether the issue is employment, trade policy, monetary policy, or virtually any other major economic issue, there is growing and inescapable connection between our nation's economic decisions and fortunes and those of the rest of the world. But this interdependence must be viewed in a broader sense than just economic. There is also a moral interdependence that extends beyond our national boundaries. We are a single moral community at the global level. Therefore, the fact that 800 million people in the world live in absolute poverty and nearly half a billion persons are chronically hungry is not irrelevant to our search for just economic policies. In the pastoral letter we suggest that the option for the poor be used as a general moral framework with which to view the international economy. Such a perspective suggests that we give high priority to North-South issues such as Third World debt that threaten the futures of some of the poor nations.

CONCLUSION

We know we cannot be true to our religious heritage and be silent on the question of economic justice. We need people who can find the moral in the midst of the human, people who are committed to the best of our tradition of liberty and justice for all. It is our hope that by calling explicit attention to the moral dimensions of economic decision making, we in the Church can contribute to the achievement of an economy that is both healthy and just, that is both dynamic and fair, that respects the freedom of the human person but also protects the rights of the weak and the poor.

I commend the committee for convening this symposium to mark the 40th anniversary of the Committee and the Employment Act of 1946. One of your stated goals for this event is to review what we have learned from the past 40 years. I hope that we have learned that economic decisions are also moral and political decisions. As we struggle to meet the new challenges posed by the changing economy let us not forget that these complex questions are ultimately about human beings and human values.

Mr. **Niekirk**. Thank you very much, Archbishop Weakland.

I want to remind the people in the audience that if you raise your hand the staff will give you paper to write your questions on and they will collect them and bring them up here to be asked.

Our next speaker is Eleanor Holmes Norton, who is professor of law at Georgetown University. She has also served as Chairman of the Equal Employment Opportunity Commission.

PRESENTATION OF ELEANOR HOLMES NORTON

Ms. **Norton**. Thank you.

In the optimism of the postworld war period, the Congress enacted the full Employment Act of 1946. The following decade saw a period of greatest economic growth and productivity in the Nation's history. Nevertheless, the goals of the act were not achieved.

In a far less robust economic climate 40 years later we seek the fulfillment of the promise of the 1946 act. The elusiveness of a goal already reached by less endowed countries raises important and sometimes painful questions of public policy. But this committee goes further. It endeavors to probe the most difficult of questions seeking to counsel on, as you put it, "creating an enconomic system that reflects American values."

Under the best of circumstances, this would be a heady, even a daring mission. Some would regard it as a perilous, even an impossible question.

I shall argue today that it is an unusually useful and important question to ask today because it may help us to see more clearly and perhaps to check a profoundly troubling development inconsistent with American economic traditions.

Put briefly, we may well be in the early stages of developing a more rigid class basis to our society, permitting it to lose the extraordinary flexibility that has provided economic mobility to most Americans as a matter of course. If we allow this to happen it will be a failure not only of economic theory and initiative. It will mark the loss of individual economic mobility and opportunity, one of the hallmark values of American life.

Your concern with the value question even in the economic context is not surprising. It is utterly contemporary. Everywhere in American life today there is a yearning for values. It is not that we have lost our values or become nihilists. The opposite is the case. We have produced a plethora of often competing and conflicting values. It is no longer an America disciplined by religion, patriarchal family ties, and accepted hierarchical order. Freed from the constraints that both enhanced and chastened us, we are a country in search of internal discipline and the values that inspire it.

The breakdown in the old American value consensus is evident everywhere. The value questions raised each and every day betray consensus. How should the family function when its members have been scattered to pursue self-realization? What subjects shall be taught in school? When does life begin? What is the proper role of the State? Never before in American life have so many fundamental issues revealed themsleves as unsettled.

The committee's concern with the values that undergird our economic system should be seen, I think, in the context of this pervasive value search.

Yet economic questions in the past several years have seemed especially polarized. A deep economic transition that includes structural economic dislocation and distress has produced a debate at fundamental levels. Does State intervention aid or retard the elimination of poverty? Indeed, does the State have an appropriate role beyond military defense? Are income transfer devices counter-productive or unfair? How much taxation is compatible with economic growth?

With your ears ringing with such questions, it is no wonder that the committee seeks for the values that should be reflected in our economic system.

But if the skepticism inherent in such questions is disquieting, it is not altogether surprising. It seems to me to spring from two sources. First, the skepticism that questions the very basis of our economic course is a deep reaction by many to 50 years of State intervention into matters heretofore entirely private—from the Social Security to the Federal Reserve function.

Second, the economic skepticism of this period derives from unprecedented economic pressures and competition that we have failed adequately to address.

Let me say a word about these two sources of economic skepticism and then suggest a basis for a value consensus.

First, the reaction to the New Deal and its progeny is an almost classical Hegelian swing away from what has been. We are now moving out of the most significant period in the 20th century. I believe the last 50 years should be viewed in this way for a number of reasons, none more important than two which stand out.

One, it is in this period that we have redefined the relationship between the individual and the State to include Government responsibility for those who lack resources and opportunity.

Two , it is in this period that we have redefined the relationship between the economy and the State to include Government regulation to avoid at least the most serious cyclical distress and the most threatening of uninhibited economic effects.

That this unprecedented use of State power in America has been overwhelmingly successful can hardly be doubted. Out of the economic course of the past 50 years has come the creation of a majority middle class society, mechanisms that have prevented a recurrence of a great depression and regulation that has checked the worst abuses of private economic power. But no intervention so large and unprecedented—or, for that matter, so successful—can accomplish all its stated purposes. This is especially the case when we encounter altogether new forces, as we now have.

Yet what has developed in many quarters in recent years is a wholesale reaction that savages the very foundation of the economic and social success of the period out of which we are now moving.

What is needed is a more careful, if more difficult, critique that builds upon the best of the most extraordinary sustained period of economic growth and prosperity our society has experienced and seeks to extend and expand it to meet a new and different set of economic challenges.

This more focused approach to the economic problems of the current period has been retarded by more than the reaction I have just described. The failure to develop an appropriate conceptual framework to assess and prescribe an economic course for the future is related to the second source of skepticism I alluded to earlier—the advent of new and much more formidable economic pressures.

American optimism that has been shaped by the vision of endless resources and boundless opportunity has been profoundly shaken by objective economic events in the 1970's and 1980's. These include the rise of the international economy that has replaced the national economy as the mediator of the American standard of living, the decline of the manufacturing sector that has been the bedrock of American prosperity and mobility and its antithesis, the rise of a low-paid service economy, tax cuts that have produced a structural deficit which for the past several years has imperiled most domestic programs, destroyed others, and now threatens military spending as well, and increasing permanent levels of unemployment that were unthinkable as recently as the early 1970's and certainly when the Full Employment Act was passed 40 years ago.

Together, these new economic developments amount to change that requires some basic economic rethinking and retooling. But instead of efforts to conceive and build an economy that can meet these new challenges, the response has too often been reactionary. What is wrong with the economy is understood by some to flow not from these profound new challenges but from the economic policies of the past, especially Government intervention.

This is demonstrably false. The economic policies of the preceding period were brilliantly successful, as the indicators of the 1950's and 1960's show. Our economic problems do not derive from old policies but from a failure to build in new policies to meet the challenges of today.

Nothing signifies this more than the prevailing wisdom that applauds the recent recovery as if it were some kind of happy ending. It is a recovery from an unprecedentedly harsh and deliberately inflicted recession that has left us with record levels of unemployment. But most seriously, it is a recovery that has distracted us from the urgent work of thinking through long-term economic policy for a future that is already upon us.

We are still approaching economic problems as if they were what they have always been in the past—the cyclical problems of a growing economy. In fact, they are the structural problems of a tired and uncompetitive economy. We have not begun to ask the right questions, much less search for the answers.

The failure is already being felt in increasing inequality of opportunity that reflects itself in economic terms. The effect on minority Americans is especially tragic because for them economic opportunity became possible only as the economy lost its old vitality.

If these trends continue unchecked, we shall surely see the development of class lines and barriers unprecedented in our society for Americans of all backgrounds. The trends to which I refer have been greatly exacerbated by economic policies since 1980 but have an origin that has been clearly visible since the 1970's.

The trends taken together are easily summarized as a wider gap between those with the most resources and those with more modest resources than has been the case at any time since the Full Employment Act was passed. The details of this disparity are too familiar to require great detail, especially since much of it has come from this committee's own research. Let me simply cite to some data that bears upon my thesis that class regidities are developing in an unprecedented way in American society.

According to 1985 census data, the least affluent 40 percent of American families received the smallest proportion of national income 15.7 percent since the Full Employment Act was passed data kept since 1947, the year after passage while the wealthiest 40 percent recveived their largest proportion 67.3 percent in 40 years.

Moreover, the 20 percent of families in the middle received their lowest share since 1947 as well. Even more disconcerting for my concern about class barriers are the generational implications of the spectacular rise in poverty among children. The poverty rate for children is double the rate for adults. One out of every two black children is being raised in poverty and two out of every five Hispanic children. Unless we intervene these children will find their way as adults disproportionably among the new structurally unemployed and will become the carriers of generational poverty and thus of class bound roots. This is already apparent among minorities who form a large proportion of the so-called underclass whose roots lie in generational poverty and joblessness. Added to these ingredients for class based economic immobility are large increases in poverty among working people. The working poor (aged 22 to 64) have increased by 60 percent since 1978. This is only some of the data that suggests that many Americans may be unable to follow the classic American pattern of rising above poverty.

The reasons as well as cures for these and similar economic problems that have new class implications are not mysterious; and much could be done in the short term to correct them. This, of course, is beyond the mission of my statement today and in any case, you will hear much by way of helpful prescription during these 2 days. But I believe that these trends speak as well to our common economic values. As a people we have not striven for an explicitly classless society. But we have sought a society without class barriers. The class mobility that has been achieved by a Nation of immigrants almost all originally poor and without skills, is the best evidence of our success as a society with fluid barriers. This success cannot continue without a rethinking of the economic prescriptions that inform the future. The withdrawal of government at such a moment when basic redirection is needed is folly. A new economic consensus can be forged only by those chosen by the people, not by impersonal market forces unguided by democratic values and imperatives.

I will skip on as my time is through. The reasons as well as the cures for these and similar problems that have new class implications are not mysterious and much could be done in the short term to correct them. This, of course, is beyond the mission of my statement today.

A new consensus—would undoubtedly draw upon the best mix of public and private initiative. By now it should be clear that this is the American way. But even more American is the goal of ever-expanding economic opportunity that scuttles the class barriers which shackle individual initiative. The underlying value our society places on economic opportunity without regard to class origins cannot sustain itself unaided in a world shaped by unyielding economic competition. It will take new vision, building on the economic success of the past, together with long-term national economic initiatives to assure this oldest of American values. Thank you.

Mr. **Niekirk**. Thank you very much.

[Applause.]

Mr. **Niekirk**. Our next speaker is John Agresto, who is Acting Chairman of the National Endowment for the Hunanities. He was previously a fellow and project director at the National Humanities Center in North Carolina, and has taught at Duke University, Kenyon College, and the University of Toronto.

PRESENTATION OF JOHN AGRESTO

Mr. **Agresto**. Thank you. I am not an economist. I am a political scientist and an American historian, and that means I will speak to this audience in what you will either consider glowing truths or platitudes of thin generality.

I also am not something else. When I originally saw the program, my name was not listed; Irving Kristol's name was listed. Even worse than not being an economist is not being Irving Kristol.

The topic of this panel is the American economic system and American values. The first thing I should like to say is that the American economic system, in its broad outlines, and American values and principles, in their broad outlines, feed each other. They have always fed each other and they are not in any substantial way in tention or in any opposition.

The panel began with a list of what some of those basic principles might be. Let me add my own as well. Basic principles in this country include liberty, prosperity, comfort, social mobility, progress. Those basic principles are intertwined with our political values, with our moral values, and with our economic goals.

Now, that being said, it is not to say that there is only one form or economic structure compatible with those principles or compatible with those values any more than it is to say there is only one particular political structure compatible with those goals and with those values.

We in this country have a Government with separation of powers, bicameralism, checks and balances, federalism, judicial review—all of which are compatible with the values that I have listed and that others have listed as well. Those are not the only forms which this Government could take and still be true to those ideals. This is not, therefore, to say that we have only one economic structure that can be true to those ideals.

But it seems to be clear that the economic structure that I see around us and that I know both first hand and from some study is fully compatible with the principles that we have. Given those goals—liberty, prosperity, comfort, social mobility, progress—we do not have an anomalous economic system in this country.

Second, the attacks on our economic structure are often attacks not primarily on our economic structure but on our moral, social, and political goals as well, on the way of life we as a people have chosen to lead. They are not always attacks on our economic structure but are, often, attacks on our moral values and ideals as well.

What, in general terms, are these broad attacks? Obviously, everyone knows that our moral-political-economic system is always openly attacked from the left. The best of the left attack goes like this: The American system is fully inegalitarian. It is a system that can only result in the conflict of the rich versus the poor. It is a system that purposely and immorally divide citizens. It is heartless. Marx would go so far as to say that ancient slavery was in itself preferable to modern capitalism in the human way you treat an individual. Second, the left also says democratic capitalism, based—as capitalism itself admits—on competition and self-interest, not only unequally distributes the goods of this world but it misconstrues the nature of the self. We in this society think of people as atoms of self-interest rather than as social beings. Moreover, the attack from the left sees moneymaking competition, and free markets. As the destroyer of social and personal linkages, of fellow feeling, all those human sentiments that lie at the base of good social and human relations.

There's also an attack on this economic system from the right. We don't hear it as often but it's a powerful attack. It goes like this: Democratic capitalism has destroyed culture. It has cultivated softness. It has destroyed traditional societal ties. It has undermined spirituality. It has lowered human life to the level of mere life, to the life of desire, satisfaction. There is in bourgeois society no nobility, no secure horizons, no order, no fervent patriotism. There is nothing in this society that is not, this attack says, philistine. Once we have given ourselves over to this economic way of life, we are nothing more than a nation of shopkeepers.

So the attack from the right, and it's a powerful attack as I said, sees this economic system and these values as a destroyer of culture and tradition.

In a sense, the left and right attacks on our system and our values are similar—free economies, free societies, and free markets breed an individualism and an egocentric materialism destructive of a health social life and a full, authentic personal life. It advances the individual at the expense of society, tradition, and community.

Thoreau spoke for both of those sides when he said, "There is nothing, not even crime, more opposed to poetry, to philosophy, to life itself, than this incessant business."

And there's also an attack on our way of life from above. As it is said, one cannot serve both God and man now. And the pursuit of money, the pursuit of economic well-being, the pursuit of comfortable self-preservation is different than the love of God. God does not ask us to pursue a life of comfortable self-preservation. We all know there's something quite odd about rightwing preachers, for example, who says that God wants everybody to be rich or comfortable or economically successful. That doesn't strike our religious sense as right.

The attack from above understands that the economic system we have in this country was in some ways meant to undermine, to undo, the curse of God on Adam and eve in the Garden. The curse said that men will seat and toil and suffer and women will feel pain. But the aim of modern economics has been to undo, to ease, that curse. It says progress, material progress, makes us happier—happier than living like the lillies of the field.

Those are the three basic objections. Are these objections true? Each one has a part, each one has a certain understanding. Are they the whole truth? Absolutely not. The amazing thing is the degree to which the economic system in America has managed to deliver the exact opposite of what its critics say it must deliver. We do not have high culture in this country but we are certainly not barbarians of culture. We are, despite the theory of competition and self-interest that lies at the base of our economic structure, the world's most generous, sympathetic, and charitable people. We are honest. We are quick to forgive. We are very often self-sacrificing. We are mild and moderate, not fanatical, and not extremists.

The system promotes, as its authors and founders knew it would promote, not noble people, not saints, but rather moderate, decent people and fellow citizens.

This economic system even though it seems to be based on only the private pursuit of gain gives us, I think it's clear to say, decent countrymen. We are, in fact, a Nation of shopkeepers, with all the vices—but also with all the virtues—that that entails.

Just to give one example, we are the only Nation in the history of the world where the words "the poor" and "the minority" are synonyms. Before us, in all nations, the words "poor" and "majority" were synonyms. When Aristotle tries to define democracy, he fluctuates between saying it's the rule of the many and the rule of the poor and then he finally says, well, it doesn't matter since the many are the poor.

We have managed to undo that; and that's no mean trick. My last word is "Let's not lose sight of what we are and what we as a people have accomplished in the modern world. In hopes of making our life better, lets not lose sight of how good and how decent our principles and our successes are." Thank you.

[Applause.]

Mr. NIEKIRK. Thank you very much, Mr. Agresto. It's a very interesting panel. I think this panel is probably about the old conflict between economic efficiency and equity. And right in the very beginning I think Mr. Yankelovich raised some interesting points about what American people really think about this. After Mr. Yankeolovich has heard the other panelists give their particular views and their particular visions on what our values should be in relation to the American economy, I'd like to call on him first and ask him what he thinks about what the American people really think about the other views of the panelists. I think that that may get us rolling pretty good here.

Mr. YANKELOVICH. I think that the strain the chairman mentioned—that many Americans regard inequality of results as a confirmation that freedom exists is very much in conflict with a concern with egalitarianism. That is, of course, the classic conflict in American life: the effort to reconcile equality and freedom.

Equality of opportunity is the way that reconciliation has taken place and in the future it will continue to be the key touchstone of average Americans for judging the proper balance of values.

There is recognition by average Americans that these values are in conflict, but if I heard some of the other speakers correctly, they were speaking in the same vein. The emphasis that Eleanor Homes Norton gave on a possible increase in class divisiveness that destroys equality of opportunity seems very much in that tradition.

I heard the panel give different emphases and express different set of concerns. There are those who are concerned with minorities. These are those who are concerned with making sure that American culture and values are not sold short. There's a concern with poverty.

But I did not hear any vasic contradiction between these concerns and fundamental American values. Different emphases perhaps, a somewhat different philosophy than the majority philosophy, maybe more emphasis on the egalitarian aspect than on the aspect of equality of opportunity, but it seems to me that that is one of the underlying themes of this panel and of the economy.

The danger in our international economy that is developing is that if the United States does not create more jobs and more economic opportunity, the system will not work. Our values need to be validated by excellence in economic performance. A healthy, viable competitive economy is the link that reconciles equality with freedom. And in such an economy I didn't see any fundamental contradiction between the views of the speakers and the American public.

Mr. Niekirk. That actually leads into a question that I have and I'd like to ask this of Archbishop Weakland. Do you accept the notion that many economists do I think that raising public spending, the deficit if you will, ultimately stifles the economy and takes out all these underpinnings to achieve all the good things that you want to achieve? Isn't that what's been going on for the last 4 years?

Mr. Weakland. The question I think is, is that the only way of meeting those needs? And one could say that there are other ways of gaining that money so that the human costs don't have to be done away with. So I'm sure the bishops have felt very strongly that enough cuts can be made in the military to take care of the social programs that they are concerned about, that it doesn't have to be just the either-or that one is faced with today.

And in looking at the programs that Eleanor talked about, we felt that some of them did work and one has to say that and get those that didn't work up to snuff.

But to leave the social questions disappear while we try to take care of other things is simply to compound the question down the road. So that one cannot take an either-or, one has to take a both-and position today, if you want to have a future that's going to be in any way solid.

Mr. Niekirk. Would you favor a balanced budget? Do you think that's necessary in the context of what you're talking about?

Mr. Weakland. I would answer here personally because it's not in our document as such. I would say yes, I do.

Could I say a word, though, about egalitarianism? Do you mind my getting in on that?

Mr. Niekirk. No. Go ahead.

Mr. Weakland. Because it came up and I think I'm one of those who brought it up and it certainly comes up in our document, what we call distributive justice, which is a little different than egalitarianism.

I don't know of anybody who would favor egalitarianism today. That just doesn't make any sense, especially in a capitalist system. But we do talk about maldistribution of wealth and income and we have two kinds of areas where this is a problem.

One is, if there are still people who are not making it, who are not obtaining their share, who are not able to be a part of this system—and if you have 35 million poor people out there, that means that the distributive question remains an important question. But also—and this is interesting to me—long before it was even thought that you could ever arrive at a point of taking care of proverty, Catholic social teaching taught that we will always have inequality. But the moment that that inequality leads to a kind of class conflict, which is when the differences between the high and the low get so far apart, then it's very difficult to form any kind of policital consensus and social consensus in a society. Then a red flag should go up that is a potential danger to your society, even though you might be taking care of all the poor.

Representative Scheuer. Excuse me. Can I ask the archbishop a question?

Archbishop, you mentioned that you're in favor of a balanced budget. Now would you like to take your position a little bit further and tell us how you think we ought to get there? Do we get there by further custs in social services that affect disproportionately the poor people that you're concerned about?

Mr. Weakland. I would take it in two ways but I'm answering here not as archibishop of Milwaukee but just as a citizen of the United States. I certainly believe one can reduce the military budget still within a safety level, and I also am not opposed to a raising of taxes when needed to take care of those social programs. It seems to me it's self-evident that these are the only ways you can do it.

Representative Scheuer. Thank you very much.

Mr. Niekirk. I'd like to ask Mr. Agresto to respond to this question. As a journalist I've spent many nights covering the debate over the Reagan budget in 1981 and the tax cuts and listened to all of the supply-side arguments and the general thesis of the supply-siders was that our economy in the past 20 years or so has been too much concerned with distributing our wealth rather than creating wealth and cutting taxes—most of you people here are very familiar with those kinds of arguments—and not paying much attention to innovation and investment and all the kinds of things that make the economy grow.

How do you respond to that in the context of what you said here today and what the other panelists have said? Do you think this is a viable kind of argument to make if we're going to have an American economy that has these values?

Mr. Agresto. You bet. Looking again as an outsider, the basic economic question that historically tends to be asked was the question of distribution. We would ask questions about a just wage. We would ask questions about distributive justice.

It dawned on the world that that was not the only economic question that had to be raised and that an ancillary if not an equally important and in some cases the most important question was not the distribution of wealth, but in fact the production of wealth. The question of how we produce wealth and how we manufacture well-being in this country is in some ways a primary, first question that has to be raised.

That is not to say that if you have gross maldistribution of wealth you're not in trouble. Of course you are. The reason we exist in this civil society, according to philosophic and political theory, is to preserve ourselves, our liberties, our property, and our own well-being. If the social and economic and political forces fail, if some of us are without the wherewithal to survive, then we recognize a right even to talk about revolution.

Nevertheless, that doesn't mean that the most important thing to consider is the distribution of wealth but where does it come from, how can we have it, how can we make it? On that score, I think it's been a healthy addition to the economic climate to raise that question.

Mr. **Niekirk**. Ms. Norton, in the last 50 years, were we just lucky we were uninvaded and not bombed in World War II and we were able to throw our weight around in the economy? All that time is ended now. Shouldn't we find ways to adjust?

Ms. **Norton**. Well, for 300 years we've been lucky. We were lucky first because we came to a country with extraordinary resources empty of people. We were lucky that we were able to import millions of emigrants whose skills matched the work to be done. We have been lucky in the last 50 years as well because we were able to have our economy recover from a Great Depression at a time when there were no real economic competitors.

We are now not so lucky. It could not last forever—our monopoly could not last forever. Its not a monopoly we got unfairly. We were not a colonial power, but it was a monopoly nonetheless. We produced most of the world's goods and we consumed most of the world's goods.

Now Third World economies all around the globe vie for the markets we had to ourselves and we cannot maintain our economic position unless we are a whole lot smarter than we are lucky, and thus far, the 1970's and 1980's have shown we are certainly not smart enough yet.

Mr. **Niekirk**. Do you think we have some responsibility to share in a way some of this wealth with some of the second and third and fourth world countries—a questioner of the Third World here puts—that may cost us some industries and companies and individuals in the long run? Any comments from you, Ms. Norton?

Ms. **Norton**. There was a time that the Third World wanted us to share resources. They no longer ask us to share. They have stolen our markets. They increasingly compete for our markets better than we do. We no longer live in a world in which the United States will be called upon to give of what she has manufactured to others.

A sea change has occurred in the international economy. To be sure, there are still economies that are barely developed that require sharing in the sense of gifts and loans. What is occurring it seems to me, however, is a much more profound economic development, and that is that the world's markets are being divided up among those who vie best for them. Sometimes others are lucky, others are able to meet world economic needs in a way we no longer can.

Thus, some falloff of the extraordinary economic growth we experienced when we had no competitors was, I think, natural. The kind of falloff we have seen, however, I think, is quite unnatural and comes from our inattention to the economic challenges that are now confronting us, a different and new set of challenges altogether.

Mr. **Agresto**. Could I add something?

Mr. **Niekirk**. Sure.

Mr. **Agresto**. I was put off by the word "lucky" both in your question and the answer.

I don't think that's true. I don't think that we can say that the cause of our economic prosperity, of our place in the world, of our comfort and security at home had much to do with luck. The releasing of the economic and productive talents of the people of this country had considerably more to do with it. Liberty, limited government, pluralism, the destruction of barriers between the States, and free trade have had considerably more to do with our economic well-being than merely luck, or our resources or the fertility of the soil.

I don't believe that Iowa by nature has more fertile soil than the Ukraine, but yet we produce a lot more wheat. That has very little to do with luck. That has to do with the releasing of certain economic talents and the fostering and the cultivation of them so that liberty, and even natural self-interest can work for everyone's good.

Mr. **Niekirk**. A question for Archbishop Weakland. Regarding your comment that the powerless must have help and that to combat the erosion of human dignity we must have a preferential option for the poor, why concentrate on just women and children? It's obvious children need help and guidance, but why single out women as a whole as being helpless?

Mr. **Weakland**. Good question. I didn't mean that the preferential option for the poor is only women and children. I selected those groups right now in the United States because I do think they stand out at this moment and statistics will show that women, especially single parents who are heads of family, so many of them cannot earn enough to take care of their own livelihood and their family and so on. So I singled out the women because, I think, that is one group that we have to deal with and certainly the children.

But there are many others and I wouldn't want to exclude them also from the option that we have to attend to them and, I think, that holds not just for the United States but also as we deal with Third World nations.

Mr. **Niekirk**. A sort of followup question which was not a followup but it came from a questioner separately but I'll ask it as a followup question. What does it do to the human dignity of a woman who is told she cannot participate as a priest? This is somewhat off the issue of economic efficiency and equity. However, I thought since this is a followup question I would go ahead and ask it.

Mr. **Weakland**. I feel that this is a very difficult issue for a woman and certainly it's one that she has every right to feel hurt about and it's one that we have to deal with.

The Catholic Church moves very slowly and to change a tradition that's 2,000 years old is not something that's going to happen without a lot of struggle and pain, and I can assure you we watch very carefully what has happened in the Episcopalian Church, the divisions and so on, and it's something that we're just dealing with cautiously.

Mr. **Niekirk**. This is a long question and I'll try to shorten it somewhat. A questioner asks: What about the moral and economic value of survival—and the question goes on to talk about military spending and he says—he or she, I don't know whether it's a he or a she—more jobs are created by putting money into a civilian economy rather than a military economy which our economy is. Do you think that nuclear money—in other words, putting money from the military into social programs would be a better way to handle it? I realize this was sort of a topic of Archbishop Weakland's paper, so I will direct this away from him and ask Ms. Norton to respond to it. Is this the way to solve the whole problem of efficiency and equity? Is it just to pick on the military?

Ms. **Norton**. Well, I think people pick on the military today because of the extraordinary preference it has received from this administration. After all, the military was experiencing increases under the Carter administration, and there was not nearly the kind of outcry there is now because there has been nothing more and nothing less today than a tradeoff between domestic and military spending. I mean, it is as if we have become more and more like the Soviets who, of course, spend all their money for military hardware while their people suffer. Never in my lifetime has America looked more like the Soviets in that way than they have in the past 5 years when we have so disproportionately spent for military means.

Mr. **Niekirk**. Any other responses from the panel on that? I thought it might raise a few thoughts.

Mr. **Weakland**. I have more questions than I do answers. I keep asking my classical capitalist theorists how much of your GNP and how much of your budget can go to military which kind of takes it out of the supply-demand framework of a good capitalist system which must be competitive, and still call yourselves really capitalists? At what portion or at what point do you begin to get conflicts between the way the military is run, that enormous portion of your budget, and the rest of your budget? So it's more a question I would have to say than it is an answer.

Mr. **Niekirk**. I think, though, that we have still kind of danced around the question here of efficiency and equity. I don't think we've really got to the point of trying to define what level of the public sector we should have in this Government. We all know that we're spending about—we're taking in about 19 percent or so of taxes and we're spending about 25 percent.

I'd like to ask on my own the three members of the panel, from an efficiency standpoint and also from the standpoint of creating the kind of economy we want, what is the right level of the public sector? We hear the Reagan administration talking about 19 percent is proper and we don't want to raise taxes to balance the budget. Others say we may have something of a measured program that includes tax increases and budget cuts to bring them down as a percentage of GNP to the range of 21 or 22 percent. What is the proper level here to maintain a good economy and have all the goodies that we all want?

I'd like to hear from each member of the panel on that because I think that is what this is really about.

Mr. **Weakland**. To me the question is a false question and falsely posed because the question has to be what are the needs out there, how do we analyze those needs concerning our people, and what can we do about them? Then, it seems to me you have to take a look at—the answers to those are not all economic. They are in many other areas and one would be foolish to think that you're going to find economic solutions to so many of the problems. Other things have to be done to help in our society, and that congeries of formulas has to be worked out.

So I would say I don't think you can ask the question at what point do you stop and then let the rest go by the wayside? The question is: How are you going to use your money best and if it takes as much as it takes? I don't know how you could settle on a limit to the needs at this moment of history without just delaying them for another 10 or 20 years and the problem getting worse.

Mr. **Niekirk**. Ms. Norton, I'd like to hear you out on this, too.

Ms. **Norton**. If I may say so, Mr. Moderator, I can appreciate your search for certainty. I can't imagine what we would say if we were a panel of economists none of whom seem to agree on questions so precise, but we are a panel of lay people who are likely to find your search for certainty highly misplaced when the question is put to us.

The fact is that to ask what percentage of GNP ought go for domestic programs vis-a-vis other things is to ask us to decide from among a whole set of variablies at any given moment in time what the percentage should be. I'm not sure that I would like to see that question answered.

At a given point in time, depending, for example, on whether there is a deficit or not and how much that is and how much need there is and what the preceding economic cycle has been, one might come up with a different figure than at another time. I don't think that our economic problems today flow from a failure at consensus on a number, particularly a percentage number. I think our questions are far deeper than that and that one has to ask far more fundamental questions and that, indeed, the answers will change based on what economic conditions are at a given moment in time.

So not only do I dodge your question, I pass explicitly and deliberately.

Mr. **Agresto**. I really do think it's a prudential question, not a question of principle, and we are in no position to answer the prudential part of the question.

There is a certain principle, however, that is involved and I'd just like to refer back to American history, and the foundations of this country do seem to say that the first object of government—and this is Madison's words—the first object of government is the safety and security of the American people.

Insofar as we then find ourselves in time of international turmoil and trouble, military needs become more prominent and predominant. Insofar as we are in international peace and not in difficult straits, then prudentially it becomes not a matter of how much do we need for our security—we may not have to spend as much militarily. That's where there is a principle involved here. The first requirement of government is for the safety and security of this country.

Mr. **Niekirk**. A questioner asks: In all the previous discussions here today the macroeconomics and the various issues, he has heard no concrete proposals for alleviating the unemployment problems. Can the moral responsibility override the practical limitations of macroeconomics to meet these kinds of challenges? Archbishop Weakland.

Mr. **Weakland**. We certainly looked into this issue and received a fair number of studies on how the unemployment could be reduced from 6 percent downward or 6.8 or whatever it is now downward. This is a question of tradeoffs as well, so it's not something that's done without cost.

On the other hand, you do have the advantage of reducing the welfare needs. You have the added income that comes from taxes of people who are working, plus, of course, not having to supply all the needs of these same people who are able to take care of themselves.

I think what we're concerned about is the fact that there seems to be no effort. We rest in a kind of complacency about that unemployment level and that is the greatest of our worries.

I would say that the technicians have come up with some possible ways of reducing it and I would hope that these would be given a lot more public debate.

Mr. **Niekirk**. Ms. Norton, this seems to be right up your alley. Would you like to respond to that?

Ms. **Norton**. The reason I think we haven't spoken to what could be done about unemployment is that we were asked to speak about values.

I think that if you hold the value of employment high, you will be willing to take more risks to decrease unemployment. We have not shown in recent years that we hold the value of employment very high at all because with every recession from the early 1970's on we have abided ever-increasing levels of unemployment and have seemed to learn to live with it, particularly since it wasn't most of us.

What I think is going to happen, frankly, is that we are going to reach a level of permanent unemployment that will bring us into intersection with our values. There will be a practical crisis because at a certain level of structural unemployment, or permanent unemployment, I don't think the people will take it any more and there will be a value crisis because people will ask what kind of people are we that, for example, we have learned to live with an unemployment level of 10 percent? And I do not think it is beyond cabal that we could learn to live with an unemployment level of 10 percent. Who would have thought we would have learned to live with an unemployment level of 7 percent? One of the reasons we can live with an unemployment level of 7 percent is that those who are unemployed are so disproportionately black and brown.

With the increase in structural unemployment among white manufacturing workers, there will grow political pressure that I think will call our values into question. It is not unthinkable to me, particularly as we see the rosy scenarios painted as we come out of this recession, that by 1990 we could get to a level of unemployment of 8 or 9 percent and say, "Wow, I'm glad that unemployment battle is over." We've got to face the fact that this creeping upward level of unemployment is something that we have become increasingly comfortable with and that it is shocking, that if we do not check it we will have a crisis on our hands. It will be not only a crisis of values; it will be another order of magnitude and one that we all may come to feel.

Mr. **NIEKIRK**. Archbishop Weakland, there are rumors that the last Synod in November nullified the final draft of the pastoral. If so, why? If not, when are you going to issue it?

Mr. **WEAKLAND**. The economic pastoral of the bishops was not discussed at all at the last Synod. It was not on the agenda and never came up. That answers your question out there I hope.

Mr. **NIEKIRK**. Another question for the Archbishop. Can qualifications for parenthood be justified morally?

Mr. **WEAKLAND**. Can qualifications for parenthood be justified morally? I would say, yes, it takes qualities to be a parent. To assume any responsibility, certainly the responsibility to raise children, yes, there are moral criteria there and I would decry as much as anybody would those who have children out of wedlock and are unable to assume those responsibilities, both men and women. One can't just restrict that to women.

So I would say, yes, and I would hope that as a church we would do our most to help in that area.

Can I say what I think is underneath that question because I get that question rather often? There's a feeling out there that if we could stabilize the concept of marriage among the poor and stabilize the family among the poor, many of the poverty issues would disappear and, therefore, we wouldn't have to pay out money for it. But I warn you that you cannot stabilize marriage among the poor unless you stabilize marriage among the affluent. And these values pervade the whole of society and you don't fix up poverty problems among just the poor. It's all levels of society.

[Applause.]

Mr. **NIEKIRK**. Thank you very much. That will conclude this particular panel. I want to thank everybody for attending and listening. There are some questions which didn't get answered, but I want you to know we had a veritable flood of them for this particular panel, so if you will please pardon us on that.

Chairman **OBEY**. I want to thank the panel very much for their being with us today and, Bill, thank you for your direction of it.

I want to add one point. One response to the question that there were no specific proposals presented today to attack the unemployment problem, I hope you will be here tomorrow because we have four more panels tomorrow, the first which is: "Creating Jobs and

Raising Income," the second: "Moving From Welfare Dependence to Work and Opportunity," and then the latter two in the afternoon, "Meeting the Challenge of International Competition," and "Creating the World Class Workforce." I think all four of those panels will focus to a very significant degree on the question of how we attack unemployment.

Also, and I apologize for this. I meant to do it earlier but I've been informed that Gardiner Ackley, a former Chairman of the Council of Economic Advisers, was here. I don't know if he is still here or not. If he is, I would ask him to stand; and if he isn't, I would apologize for not mentioning it early. Evidently he's already left.

I would also like to express my appreciation—and I do this now so I won't forget it tomorrow when we wrap up—I want to express my appreciation to the staff of the Joint Economic Committee for the work they have done in preparing this symposium. As Chairman, all I've had to do is worry about it, but they have done the work. And I would especially like to thank the administrative staff, people like Pam Reynolds, Joan Mutz, Mike Musto, Dave Battey, Doris Irvin, Lennea Tinker, Mark McKaig, Juanita Morgan, Carole Geagley, Jeanette Crenshaw, and a number of others, for the tremendous amount of work that they have done behind the scenes in order to help us put this on.

[Applause.]

Chairman OBEY. I especially thank you in the audience for your attendance and participation in the questioning process and would urge you to join us again tomorrow when I promise we will start at 9 o'clock.

[Whereupon, at 5:05 p.m., the committee recessed, to reconvene at 9 a.m., Friday, January 17, 1986.]

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A SYMPOSIUM ON THE 40TH ANNIVERSARY OF THE JOINT ECONOMIC COMMITTEE

FRIDAY, JANUARY 17, 1986

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met pursuant to recess, at 9 a.m., in room 345, Cannon House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Scheuer; and Senator Sarbanes.

OPENING REMARKS OF REPRESENTATIVE OBEY, CHAIRMAN

Chairman Obey. If I could have your attention I'd like to begin. I would ask the next panel to please come up and take their seats.

Let me welcome you again to the second day of the Joint Economic Committee symposium celebrating the 40th anniversary of the passage of the Employment Act of 1946.

As you know, yesterday we had four panel discussions which focused on the deficit and its assessment, its measurement, and its role in our economy. We had the second panel discussing various macroeconomic issues, a third panel on productivity, and a fourth panel on the relationship of economic goals to our social and cultural and human values.

Today we have four panels which will be focusing on creating jobs and raising income, moving from welfare dependency to work and opportunity, meeting the challenge of international competition, and creating a world class work force.

Before I introduce the moderator for the first panel this morning, I want to take care of a personal obligation that I feel. Yesterday I thanked the administrative staff of the Joint Economic Committee for all the work that they did in putting together this 2-day conference. Today I would like to express my appreciation to the policy staff which also worked very hard so that this symposium would be focused on the issues that were of greatest importance in terms of defining where we go now in the economy and in the management of our economy.

I would especially like to express my thanks to Scott Lilly, the staff director; to Don Terry, the deputy director; and to Steve Quick, the chief economist for the committee, along with the entire professional staff. I don't want to try to name everybody because I will undoubtably leave somebody out, but I do want to thank the staff for their work.

I want to pay a special tribute to a person who is leaving the staff. Bill Maddox has served as the information officer for this committee for 7 years. He is the fellow charged with the responsibility of trying to make what the politicians on this committee say appear intelligible to the rest of the world. He is leaving to go back to his Texas related obligations and as a rejected Okie who later moved to Wisconsin, I have mixed feelings about that. But I do want to express my deep appreciation to Bill and my regret that he's leaving and wish him well. I know that the people who worked with him on the press throughout the years will appreciate the professionalism with which he has handled his job and the personal grace with which he handles the pressures of that job; and I hope that his successor will make the same kind of record in years to come.

Let me now introduce the topic for the first discussion this morning. I think that for most people the two key questions for economic policy are how we create enough jobs, at least for most people in the society—how we create enough jobs and how do we ensure that those jobs pay decent and rising income?

While we once thought that job growth and income growth went hand in hand, there has been somewhat of a tendency in recent years to see those two as potentially contradictory goals. Some have argued that income growth is the key to economic prosperity which in turn will lead to job growth. This analysis leads toward policies to improve the skills of the work force, through education, training, to assure some kind of parity in the abilities of labor and management in the collective bargaining process and, if necessary, to provide a degree of shelter for American firms from competition with very low wage countries overseas.

On the other hand, it's argued by some that policies which increase wages for the employed also reduce job opportunities for the unemployed and that growth requires increasing wage flexibility. Policy prescriptions growing out of that analysis include things such as two-tiered wage agreements, youth subminimum wage, a reducing role in Government's actions as a regulating mediator in the marketplace.

The issue has a number of dimensions and to explore those dimensions today we have a panel of experts to share their views with us. And to moderate that panel we have Elaine Povich, who is a graduate of Cornell University and I think one of the rising stars among the press in Washington. She has been with the UPI for 10 years and currently covers Capitol Hill with an emphasis on budget and economic issues.

Elaine, it's all yours.

PANEL: CREATING JOBS AND RAISING INCOMES—ELAINE POVICH, MODERATOR

Ms. Povich. Good morning. Thank you for coming out this morning to hear this panel.

When I was looking over the topic for this morning I remembered that when I was a child growing up in Maine my father always used to say that any topic in the world, no matter what it was, reminded him of a story. Heredity being what it is, I was looking over the "Creating Jobs and Raising Incomes" topic for this morning and it reminded me of a story.

There was a man once who had a beautiful garden and he was working in his garden on a hot summer day and a clergyman happened to come by and he saw the man working between the rows of beautiful flowers and lovely vegetables and he looked down and said, "My, that's a beautiful garden that you and God have there together." And the man looked up from his hoe and said, "Thank you very much, but you should have seen it last year when God had it alone."

With that small tribute to the work ethic, we will turn to our topic for this morning, "Creating Jobs and Raising Incomes."

Our first panelist is Bennett Harrison, who is a professor of political economy and planning at the Massachusetts Institute of Technology. He is a planner in describing the changing shape of work and income in the American econony.

PRESENTATION OF BENNETT HARRISON

Mr. HARRISON. Thank you.

You've heard a lot in recent weeks in Washington from the Census Bureau, the Joint Economic Committee, the Urban Institute, and the Wisconsin Poverty Institute, about increasing inequality in family incomes. This morning I will present new research results on trends in inequality in the wages and salaries of individual American workers, something I think you've not yet heard much about.

Inequality among American workers in their annual wages and salaries declined steadily through the 1960's and well into the decade of the 1970's. Economic growth was responsible, together with job-creation programs of the Federal Government.

Somewhere between 1975 and 1978 inequality in the distribution of wages and salaries took a sharp U-turn upward. This was before the election of Ronald Reagan, before the passage of the sharply regressive tax act of 1981, and even before the official commencement of the monetarist experiment in 1979.

Wage inequality among Americans has been on the increase ever since.

What's causing the increasing inequality of wage incomes among American workers? You don't get to hear this very often from economists, but I am quite prepared to say this morning that we don't yet know for sure. Barry Bluestone and I are currently writing a book on the new inequality in which we will set out our best guesses.

What I've come to report on this morning has to do with what did not cause what we're calling the great U-turn in inequality in the labor market in the United States.

The explanations that have been most commonly suggested in recent years by Washington-based researchers, columnists, and politicians are the business cycle, the entrance of the baby boom generation into the work force, and fluctuations after 1973 in the exchange value of the American dollar.

In fact, we conclude that these three variables together explain at most a third of the year to year variation in wage and salary inequality since the Great Society left town in January 1969.

We hear a lot of talk these days about the need for greater wage flexibility in order to achieve enhanced competitiveness with foreign businesses. All of the mechanisms now being proposed or already in place—the substitution of wage bonuses or the addition of wage bonuses to part of the fixed contractual rate of pay, two-tiered company wage systems, the proposal to create a subminimum wage for young people—all of those proposals or policies would have the effect of exacerbating wage inequality among workers, to a great extent regardless of their particular skills and contributions to social productivity.

As we show in our paper the trend in wage inequality had already turned upward even before these new schemes were introduced into the workplace and into official discourse in Washington.

To make the situation even worse by the exercise of deliberate public policy or by public sanctioning of private business policy could come back to haunt us in the future. If it turns out that we are indeed facing a long-term tendency toward increasingly unequal wage incomes among American workers, work incentives and conceivably even long-run economic growth could be threatened. (Keynes repeatedly argued that there could be too much inequality.)

Perhaps even more disturbing is the fear expressed by a growing number of journalists and political analysts that the frustrated expectations of significant numbers of younger middle class workers unable to attain the living standards of their own parents could lead down the road to potentially serious social unrest.

Let me now turn to the details. There are a number of different ways one can measure inequality. This is a highly technical matter; suffice to say the measure we use is the variance of the log of annual wage and salary income. This is really the single most standard and straightforward definition used by most economists.

By concentrating on annual labor incomes rather than on hourly wage rates, what we're doing is deliberately including in our measure both fully employed workers and those who work for only a portion of the year. We strongly suspect that an important part of the story of growing inequality in the labor market is the fact that it's getting harder and harder for people to find year-round full-time work.

But if that bothers some of you, I can tell you—and you will see it in the paper—that the U-turn I've described—and in particular this sharp increase in inequality beginning in the mid to late 1970's—shows up in the data even among those people who are employed year-round full-time. It shows up in every group in the population.

During the long macroeconomic expansion of the 1960's, wage and salary inequality fell dramatically. The decline continued—albeit at a slower rate—until about 1978. In that year the pattern of inequality in annual labor income underwent an abrupt U-turn, rising rapidly thereafter.

By 1983, our index of wage inequality was about 14 percent about its levels of 1978 (only 5 years before) and 7 percent above its level of 21 years before (back in 1963). We now have an unprecedented degree of inequality in the labor market.

The U-turn appears in every series we've studied: year-round, full-time workers, men and women, youth and middle-aged persons as well. Every subgroup shows a sharp increase in inequality after the middle of the 1970's.

The first of three conventional wisdoms about wage inequality that we've been able to subject to reasonably rigorous scrutiny concerns the business cycle. The theoretical reasons why many labor economists believe that business cycle fluctuations can affect wage dispension are complex. They are laid out in the paper but I think I'd better not get into the details here.

Suffice it to say that the policy implication of this view that "it's all the business cycle" is that sound macroeconomic policy can presumably smooth the path of aggregate economic growth and in the process promote a continued tendency toward income equality. We heard this sort of thing yesterday in Alan Blinder's remarks: macroeconomics will cure an awful lot of your ills.

There is no doubt that the 1970's was a rocky decade for the U.S. economy, with three recessions between 1970 and 1980. But when we statistically control for the effects of year to year variations in the cycle (whether measured by the aggregate unemployment rate or by the Federal Reserve Board's index of capacity utilization) the U-shaped pattern of inequality in individual wage and salary incomes is unaffected. The movement of the business cycle is simply not the cause of growing wage inequality in the United States.

The second major explanation one reads about regularly, especially on the editorial pages of the newspapers, is the entrance into the work force of the post World War II baby boom generation.

Standard economic theory leads to the inference that an excess supply of labor thrust into the work force in a relatively short period of time would (holding other things constant) depress the wage of that group, thereby increasing wage differences between younger and older workers. And that, it is sometimes said, is what is doing it, if indeed there is an "it" to this story of wage inequality at all.

The policy implication seems to be that we need do nothing. The inequality will disappear by itself as the baby boomers grow up.

Well, there is no doubt there has been a baby boom and there's no doubt that the baby boom plunged into the work force with vengeance in the 1970's. The share of the civilian labor force made up of workers under the age of 35 rose from 41 percent in 1969 to 51 percent 10 years later. And yet once again the conventional wisdom on this score simply is statistically unsupportable.

After statistically removing the effect of both the business cycle and the baby boom, we see a pattern of wage inequality which is fundamentally unchanged. It declines through the mid to late 1970's and then shoots up. In the equation, the baby boom variable is simply never statistically significant. It's there. It's real. It's happening, but it's not causing the increase in wage inequality.

Finally, there is the last of the three popular explanations. Another widely held view, much more interesting to us, is that the increase in the exchange value of the American dollar after 1980, weighed against the currencies of our major trading partners, has so decimated American export industries as to dislocate especially those factory workers who are predominantly middle wage earners, and that this is what is responsible for growing income inequality.

If so, we are told the correct remedy once again, not surprisingly, is macroeconomics—get the deficit down, get the exchange rates right, and we'll be fine.

Well, since the exchange rate did not begin to rise until 1980 and wage inequality began to turn up in—or shortly before—1978, this factor cannot possibly explain the timing of the U-turn in wage inequality. It's simply impossible. It occurred at least 2 years earlier.

The formal statistical analysis shows that exchange rates are correlated with wage inequality. They certainly make things worse, but not by much. According to the formal econometrics, the partial explanatory power of exchange rates is quite small. Indeed, taken altogether, baby boom, business cycle, and exchange rates explain at most a third of the increase in wage inequality in the United States.

Please note that we are *not* saying that the crisis in our export industries has not affected the demand for high wage labor; Lester Thurow has shown quite conclusively that it has. What we seem to be discovering is that the high exchange rates are not the only cause of our export losses!

Let me conclude by calling your attention to a special irony that emerges from this research.

Since the 1960's, the very mention of the word "inequality" has tended to raise images of the black inner-city ghetto or the desperately poor rural hollow. In both the popular media and political forums, inequality has for all practical purposes been a synonym for poverty.

The new findings on inequality that are emerging from a number of different research institutes now suggests that this comfortable notion has become outmoded. The sense of relative deprivation, frustrated expectations, falling behind, being badly paid, having trouble catching up to one's parents—this is becoming a common experience of a growing number of Americans. They are white as well as persons of color. They are men as well as women. And even having a full-time year-round job is no longer a guarantee of being sheltered from this experience.

[The complete presentation of Mr. Harrison follows:]

to be presented to the Fortieth Anniversary
Symposium of the U.S. Congressional Joint
Economic Committee, "The American Economy in
Transition", Washington D.C., Jan. 16-17, 1986

The Great U-Turn:

Increasing Inequality in Wage and Salary Income in the U.S.

Bennett Harrison

Chris Tilly

Barry Bluestone [1]

Inequality among American workers in their annual wage and salary incomes declined steadily throughout the 1960s, and well into the decade of the 1970s. Then, somewhere between 1975 and 1978, the distribution of wages and salaries took a sharp U-turn. This was before the election of Ronald Reagan, before the passage of the sharply regressive tax act of 1981, and even before the official commencement of the monetarist experiment in 1979. Income inequality has been increasing ever since.

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[1] The authors are, respectively, Professor of Political Economy and Planning, M.I.T.; Ph.D. candidate in Economics and Planning, M.I.T.; and Professor of Economics, Boston College. Hank Farber and Maryellen Kelley provided helpful and timely criticism.

What is causing increasing polarization of wage incomes among American workers? At this point, we do not know for certain. The factors most commonly suggested in recent years by Washington-based researchers, columnists, and politicians—the business cycle, the entrance of the baby boom generation into the workforce, and fluctuations after 1973 in the exchange value of the American dollar in international trade—explain at most a third of the variation in wage and salary inequality since the Great Society officially left town in January, 1969. That these conventional wisdoms explain so little suggests the need to probe much more deeply into the changes that have taken place in the deep structure of the American economy over the past fifteen years, and how corporations and governments have responded to those changes. It is in that direction that our future research lies.

We hear much talk these days about the need for greater wage "flexibility", in order to achieve enhanced "competitiveness" with foreign business. All of the mechanisms now being proposed or already in place — the substitution of wage bonuses for fixed, contractual rates of pay, two-tiered company wage systems, and the creation of a sub-minimum wage for younger people—would almost certainly have the effect of exacerbating wage inequality among workers, regardless of their particular skills and contributions to overall productivity.

As we will show in this paper, the trend of wage inequality had already turned upward even before these new schemes were introduced into the workplace (and into official discourse in Washington). To make the situation even worse through deliberate public policy (or by public sanctioning of private business policy) could come back to haunt us in the future. If it turns out that we are indeed facing a long-term tendency toward increasingly unequal wage incomes, work incentives (and conceivably even long run economic growth) could be threatened. Perhaps even more disturbing is the fear—expressed by a growing number of journalists and political analysts—that the frustrated expectations of significant numbers of younger workers unable to attain the living standards of their own parents could lead to potentially serious social unrest.[2]

If market forces (and past public policies) are indeed giving us an increasingly polarized distribution of income, it is only a matter of time before a large (and probably increasingly diverse) mass of citizens are going to begin pressing the federal government to correct these inequities. At a time when everyone in Washington is trying desperately to fashion ways to reduce the federal budget deficit, what the country surely does not need is yet another source of pressure on an already fragile public sector.

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[2] A bevy of prominent national economic journalists—Peter Behr, Thomas Edsall, James Fallows, Jeff Greenfield, Robert Kuttner, Jane Seabury, Robert Samuelson, Victor Zonana, to name only a few from the print media—certainly seem to take this matter seriously (although they are far from agreed on the probability of its occurrence). Edsall is using the apparent fact of this economic class polarization to fashion a political theory about voting patterns (Edsall [1983, 1985]).

I. The Revival of Concern With Income Inequality

The past year (1985) has seen an extraordinary revival of public interest in the problem of income inequality. So far, this interest has focussed almost entirely on what is happening to the distribution of family incomes. There has been a flood of academic papers, reports written for congressional committees, and an important new book.[3] Taken together with the earliest statements on this subject in the current period (Levy and Michel [1983]; Rose [1983], and Thurow [1984]), all of this work indicates (to varying degrees, depending on the specific definitions in use) a rise in family income inequality in the U.S. since at least the middle of the last decade.

All sorts of explanations have been offered for this "stylized fact". Some suggest that it is only a temporary phenomenon, an artifact created by such transitional developments as the movements of the business cycle, fluctuations in the exchange value of the dollar against foreign currencies, and the entry of the "baby-boom" generation into the workforce. Consider the latter hypothesis. The crowding of the labor market for young adults would (it has been suggested) depress the wages and family incomes of that age cohort, thereby increasing income dispersion between younger and older workers (and probably among the younger workers, as well). As the baby-boomers mature, this age-based source of inequality will (it is predicted) dissipate.

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[3] See, for example, Belous, LeGrande, and Cashell; Blackburn and Bloom; Danziger and Gottschalk (1985a and b), Levy and Michel (1985), and Thurow(1985).

By contrast, others have identified more long-term, structural shifts in economic and demographic relationships as likely causes of growing inequality. Thus, for example, two of us have argued elsewhere that American workers have become increasingly exposed to competition from much lower-paid (but, in some industries, nearly equally productive) workers in other countries. Moreover, so long as this competition from offshore labor is even potentially present, American corporations are able (and, it would seem, increasingly willing) to invoke it as a lever in the struggle over the distribution of income between wages and profits at the level of the firm. The effects of this new international wage competition, being highly uneven across industries, occupations, and regions, could well be responsible for the growing inequality in domestic labor incomes.[4]

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[4]. Bluestone and Harrison (1982). The mechanisms that mediate the relationship between the new global competition and the domestic distributions of employment and income include greatly increased import penetration of the domestic market of the U.S., but also the expanded capacity of American companies to produce (or to "source" from) foreign locations--or to credibly threaten to do so. Similarly, firms are under some pressure to automate their domestic operations in order to make their unit labor costs more internationally competitive. One effect of these developments has been to force many (especially blue-collar) workers in depressed export-oriented industries to "skid" down into lower wage, typically service sector jobs (Gordon, Schervish, and Bluestone; Flaim and Sehgal). This would also increase the dispersion of labor incomes. Even those mainly middle-level wage-earners who do

Similarly, deomographic theories suggest that rising income inequality mainly reflects growing disparities in family structure. Proponents of this explanation cite the confluence of the growth of two-earner families at one end of the income distribution, and single parent families at the other (Blackburn and Bloom). Some feminist authors explain the latter by rising divorce rates (made affordable by increasing female labor force participation) and—for black women—increasing rates of incarceration of young black men (Darity).

In a new book, we will explore the origins, magnitudes, and possible political consequences of the growing polarization of incomes and communities in "post-industrial" America. Our review of the evidence will of course begin with this question of what has been happening to family incomes. But probably the most important part of our work is addressed to a question that seems not to have yet made the transition from the technical journals to the congressional hearing rooms: to what extent is the

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(continued)

not actually lose their jobs may still be forced to accept declines in their relative wages as a result of concession bargaining impelled by that same threat of international competition (Slaughter). Finally, the flight of American capital into financial speculation (especially the rash of highly-leveraged mergers and acquisitions)--activities which arguably create a more unequal mix of jobs than would the rebuilding of the nation's physical infrastructure, or the revitalization of the machine-tool industry-- might also be interpreted at least in part as an attempt to restore short-run profits that had been eroded during the 1970s by foreign competition.

apparent trend toward growing income inequality grounded in the labor market? At the very least, we should want to know whether the distribution of wages and salaries of individual workers is itself becoming more unequal.[5]

To the extent that the income from working—wages, salaries, and cash benefits—*is* becoming distributed more unequally among employees, the potentially destabilizing consequences go far beyond social unrest *per se*. For example, consider the problem of *work incentives*. In a capitalist economy, some degree of wage inequality is unquestionably functional to the efficient operation of labor markets. Wage differentials signal occupational shortages and surpluses. Higher than average wages constitute a payoff to experience in many work settings, and can therefore be expected to induce a higher degree of job-attachment than might otherwise be forthcoming. However, beyond a certain point, wage differentials can become counterproductive. Albert Hirschman has suggested that the perception that a person is receiving unequal treatment can lead her or him (or an entire class of people) either to readjust expectations *or* to withdraw from full participation in some social process ("exit"). The danger in the present context is that *rising* inequality—a *growing* gap between rich and poor—will be perceived as unbridgeable. That could undermine work incentives and thereby further erode already lagging productivity growth.[6]

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[5] For other research on the subject of inequality in labor incomes, see Bell and Freeman; Bluestone, Harrison and Gorham; Gottschalk and Dooley (1982, 1984, 1985); Henle; Henle and Ryscavage; Lawrence; Levitan and Carlson; Mecoff; Noyelle and Stanback; Rosenthal; and Sassen-Koob.

In this paper, we offer some preliminary findings on trends in inequality in individual workers' wage and salary incomes since the 1960s. Our objectives are twofold. First, we will demonstrate that, after a long period of decline, inequality underwent a remarkably abrupt "U-turn" in the latter half of the 1970s. Second, we will test several of the most popular conventional hypotheses about rising income inequality. These concern the business cycle, the baby-boom, and the exchange value of the dollar. We will show that, taken together, these three factors explain only a small part of the growing inequality in individual wages and salaries (about a third, to be precise). In our opinion, these findings invite a re-opening of the search for deeper, more fundamental explanations for what appears to be a secular worsening of the distribution of labor income in the U.S.

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[6] A parallel macroeconomic danger is the threat to the aggregate rate of economic growth. "Underconsumptionism"--according to which a tendency toward income inequality may depress consumption spending and, on balance, retard short-run cyclical recoveries and possibly even promote recessions--is an old debate, not to be settled here (the subject is comprehensively reviewed in Habeler). In this era of almost obsessive concern for increasing the national rate of savings, John Maynard Keynes' endorsement of the basic underconsumptionist thesis of Hobson has been all but forgotten: "It is the first explicit statement of the fact that capital is brought into existence not by the propensity to save but in response to the demand resulting from actual and prospective consumption" (Keynes, p. 368).

In any case, whether the marginal propensity to consume is or is not inversely related to the level of income, such that regressive redistribution from lower to higher income classes could be expected to lower the size of the multiplier and thereby retard economic growth, is an empirical question which is completely ignored in the contemporary macroeconomic literature, where the consumption function is simply assumed to be linear in current (or lagged) income. Perhaps the recent discoveries of growing income inequality in the U.S. will stimulate new empirical research in this area.

II. Inequality in Wages and Salaries[7]

There are any number of ways to characterize "inequality". In this paper, we employ the economist's most standard indicator: the variance of the natural logarithms. By concentrating on *annual* labor income, we are including in our measure both fully employed workers and those who are able (or choose) to work for only a portion of the year. At this point in our research, we deliberately did not want to truncate the sample to year-round employees (or to study, say, hourly wage rates). We believe that variation in the hours and weeks of employment available to a person in the jobs (s)he holds constitutes fully as important a criterion for evaluating the quality or adequacy of that person's work situation as does the hourly rate of pay.

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[7] Our data for this analysis were drawn from a special version of the computer tapes containing the U.S. Census Bureau's March *Current Population Survey*. This file was generously provided to us by Professor Robert Mare of the Department of Sociology, University of Wisconsin. The sample size of workers who had at least some annual wages or salaries ranges between 27,241 and 74,319 individuals across the twenty-one years in Mare's file. The March interviews were conducted in the years 1964 - 1984. However, the "annual wage and salary income" variable refers to the previous calendar year. Hence we refer to our observations as occurring in 1963-83. Apparently there were significant definitional and/or coverage changes after March 1969--at least in the Mare file--which resulted in sharp discontinuities between the (calendar) 1968 and 1969 estimates of virtually all the variables of interest to us. It therefore seemed advisable to treat the data as two discrete time series: 1963-68 and 1969-83. In the present paper, we focus on the latter period.

During the long macroeconomic expansion of the mid 1960s, wage and salary inequality fell dramatically (fig. 1). The decline continued (albeit at a slower rate) until 1978. In that year, the pattern of inequality in annual labor income underwent an abrupt U-turn, rising rapidly thereafter (fig. 2). By 1983, what we'll abbreviate as "wage inequality" was considerably above the level of the late 1960s. This is a robust finding. To at least some extent, the U-turn appears in every series we studied: year-round, full-time workers, men and women, youth and middle-aged persons. Certainly every subgroup shows a sharp increase in inequality after the middle of the decade (appendix figures A3-A8).[8][9]

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[8] Although we think that wages and salaries is the preferred indicator of labor income, many economists and sociologists choose to study "earnings" (which includes the incomes of independent consultants, small business owners, self-employed farmers, etc.). Our data on earnings also show a U-turn, although the trough occurs somewhat earlier in the decade (appendix figures A1, A2).

[9] The discovery of the U-t[illegible]s especially interesting in shedding light on the findi[illegible] of other researchers. Thus, for example, by looking at only [illegible] years -- 1969 and 1983 -- Robert Lawrence of the Brookings [illegible]itution completely missed the dramatic switch in the direction of change in inequality, which did not occur until after the mid-1970s. As a result, his own estimates of polarization, while obviously correct on their own terms, give a misleading picture of the extent of the changes over the more recent past.

Analogously, by studying patterns of wage dispersion only among men, Peter Gottschalk and Martin Dooley missed an important difference in inequality by gender. Their path-breaking research demonstrated that male earnings inequality had been increasing

The first of three "conventional wisdoms" about wage inequality that we have been able to subject to rigorous econometric scrutiny concerns the business cycle. It is widely held that wage differentials contract during periods of macroeconomic expansion and widen during recessions. The reason conventionally offered by labor economists is that high wages tend to be relatively "stickier", i.e. more well-protected by explicit or implicit contracts, than low wages (middle-level wages have their own forms of protection, such as unionization and civil service status). Low-wage jobs are far less likely to be protected. In recessions, it is therefore the low wages which tend to be eroded vis-a-vis the rest, while during recoveries, employers are relatively freer to augment low wages if temporary shortages appear. The policy implication is that "sound" macroeconomic policy can smooth the path of aggregate economic growth and, in the process, promote a continued tendency toward income equality.

(continued)

since the mid-1960s (their time series terminates in 1977). Appendix figure A6 reveals that wage and salary inequality among women was actually falling throughout that same period. Together with the fact that the mean of women's wage and salary income was (slowly) approaching that of men throughout these years, this was sufficient to pull the aggregate distribution in the direction of greater equality, up until 1978. Both groups then experience a roughly similar degree of rising inequality beyond that point.

Fig. 1

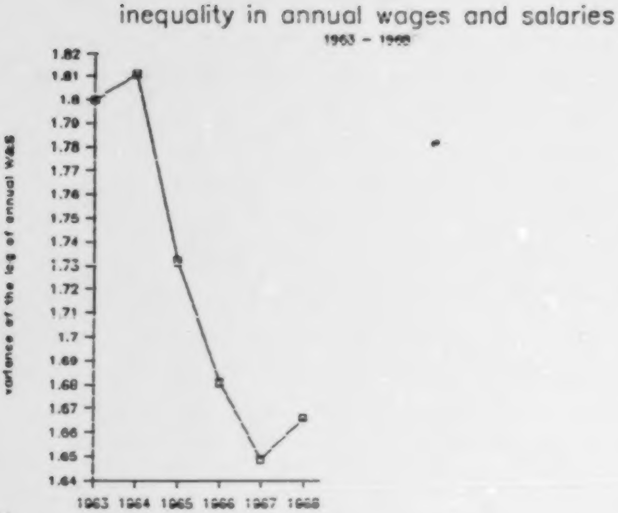
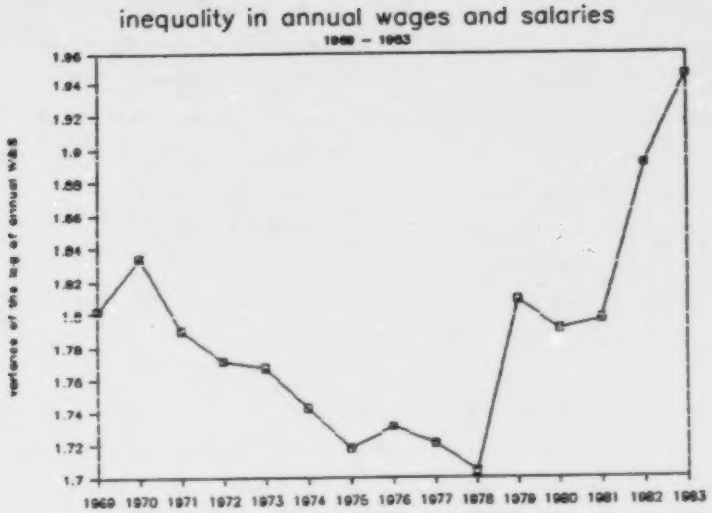

inequality in annual wages and salaries
1963 - 1968
variance of the log of annual W&S
1.82
1.81
1.8
1.79
1.78
1.77
1.76
1.75
1.74
1.73
1.72
1.71
1.7
1.69
1.68
1.67
1.66
1.65
1.64
1963
1964
1965
1966
1967
1968

Fig. 2


inequality in annual wages and salaries
1969 – 1983
variance of the log of annual wages
1.96
1.94
1.92
1.9
1.88
1.86
1.84
1.82
1.8
1.78
1.76
1.74
1.72
1.7
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

There is certainly no doubt that the Seventies was a rocky decade for the U.S. economy, with three recessions between 1970 and 1980 (figure 3). Yet, when we statistically control for the effect of year to year variations in the cycle—whether the latter is measured by the aggregate rate of unemployment or by the Federal Reserve Board's index of capacity utilization—the U-shaped pattern of inequality in individual wage and salary incomes becomes, if anything, even more pronounced (figure 4).[10] The movements of the business cycle are simply not a statistically significant cause of the variations since 1969 in the degree of wage inequality in the U.S.

Another explanation of aggregate income inequality is the entrance into the workforce of the post-World War II baby-boom generation. As was explained in Part I of this paper, standard economic theory clearly leads to the inference that an excess supply of labor offered by younger workers will, holding other things constant, depress the wage of that cohort, thereby increasing inter-generational wage variations. [11] The policy implication seems to be that we need do nothing about any apparent trend in growing inequality; it will disappear by itself as the baby-boomers mature.

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10. These and all other multiple regression results are given in appendix tables A1 and A2.

11. This of course assumes that newly-minted 23-year-old college graduates are not generally considered by companies to be close substitutes for 46-year-old experienced workers—an assumption we would not challenge for the purposes of this inquiry.

Fig. 3

national unemployment rate

1969 – 1983

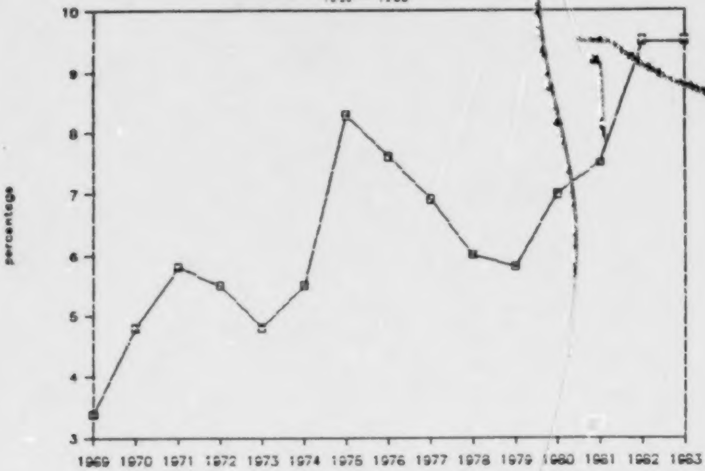
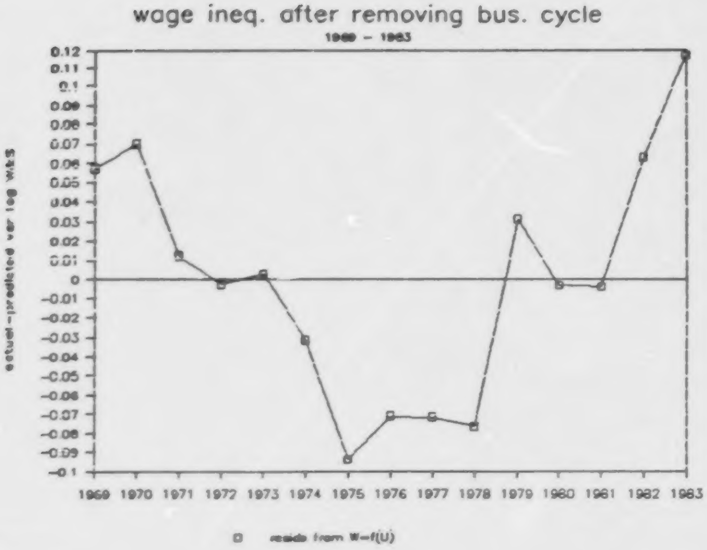


Fig. 4


wage ineq. after removing bus. cycle
1969 - 1983
actual-predicted var log wks
0.12
0.11
0.1
0.09
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
-0.01
-0.02
-0.03
-0.04
-0.05
-0.06
-0.07
-0.08
-0.09
-0.1
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
resids from W=f(U)

That the baby-boomers' entry into the world of work probably created precisely such conditions of excess supply is strongly hinted at by the numbers in Figure 5. The share of the civilian labor force made up of workers under the age of 35 rose from 41 percent in 1969 to 51 percent only ten years later. And yet once again the conventional wisdom turns out to be empirically difficult to support. After statistically removing the effect of both the business cycle and the baby boom, we see a pattern of wage inequality which is fundamentally unchanged (Figure 6). The great U-turn of the late 1970s is still apparent. [12]

Still another widely-held view is that the 38 percent increase in the exchange value of the American dollar between 1980 and 1983, weighed against the currencies of our nine major trading partners, has so decimated American export industries as to dislocate factory workers who are predominantly "middle-level" wage earners. The implication seems to be that a policy of judiciously managed trade, combined with reduced federal deficits (to bring

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12. The baby-boom hypothesis held that the phenomenon of increasing wage inequality (or, in some arguments, bi-polarization) was primarily a problem for younger workers--and a temporary problem, at that (cf. Lawrence). In fact, when we break out the two prime age groups 25-34 and 35-54, we discover that the facts are exactly the opposite of the conventional wisdom (Figures A7 and A8). The younger group actually experiences declining inequality well into the decade, while inequality begins rising for the older cohort as far back as 1972.

Fig. 5

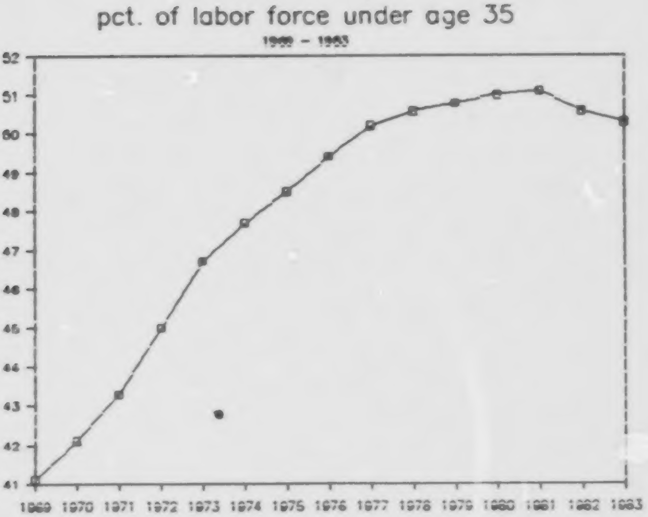
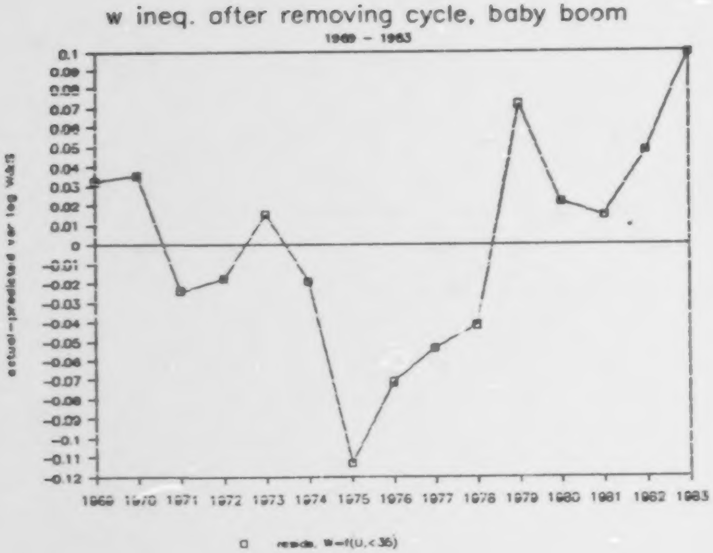

pct. of labor force under age 35
1969 - 1983
52
51
50
49
48
47
46
45
44
43
42
41
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. 6


w ineq. after removing cycle, baby boom
1969 – 1983
actual−predicted var log wage
0.1
0.09
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
−0.01
−0.02
−0.03
−0.04
−0.05
−0.06
−0.07
−0.08
−0.09
−0.1
−0.11
−0.12
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
□ resids. w=f(U,<36)

down interest rates and therefore the foreign demand for dollars), can substantially eliminate this dollar-based source of trading disadvantage, thereby restoring the vitality of U.S. export industries and the concomitant expansion of "good" jobs.

Since the exchange rate did not begin to rise until 1980, we already know that this factor cannot possibly explain the timing of the U-turn in wage inequality, which occurred at least two years earlier (figure 7). Certainly the rapid increase in exchange rates is correlated with the rise in inequality. To find out how correlated, we again ran multiple regressions, this time to statistically remove the joint effects of all three explanatory variables: the business cycle (measured by the unemployment rate), the baby-boom (measured by the share of the workforce in each year under the age of 35), and the trade-weighted exchange value of the dollar. As the regression parameters in Appendix table A1 reveal, this model explains only about a third of the year to year variation in wage inequality. Figure 8 confirms that, while the three predictors do have some impact on the dependent variable, the underlying parabolic time path of our indicator of wage inequality is still clearly discernible in the data.[13]

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13. The results are virtually identical when the Federal Reserve Board's capacity utilization index is used instead of unemployment to measure the business cycle. We also tried a first difference model, regressing the change in wage inequality on year to year changes in unemployment, age mix, and exchange rates. In these regressions, the predictive power of the three variables disappeared entirely! Finally, to be even more certain about our conclusions, we fit a second-degree spline regression to the residuals displayed in Figure 8, with a knot at 1977. The results, displayed in Appendix Table A2, confirm a highly

III. A Research Agenda on Wage Inequality

Our research into the origins, magnitudes, and potential political and economic consequences of the tendency toward increasing income inequality in the U.S. has only begun. There is still much to learn. Five questions, in particular, will dominate our efforts in the spring and summer of 1986.

1. How many people are earning high, middle, and low wages? First, the finding of growing inequality, as measured by the variance of the wage and salary income distribution, is consistent with many different sorts of changes in the shape of that distribution over time. For example, is it the case that the increasing inequality is attributable mainly to growth of the upper end? (this might be called the "rich are getting richer" hypothesis). Or perhaps the situation is the opposite, and it is the lower end of the distribution which is growing ("the poor are getting poorer"). It

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(continued)

statistically significant change of sign in the time path of wage inequality (after controlling for cycle, age, and exchange rates) from negative (indicating declining inequality) between 1969 and 1977 to positive thereafter.

Fig. 7

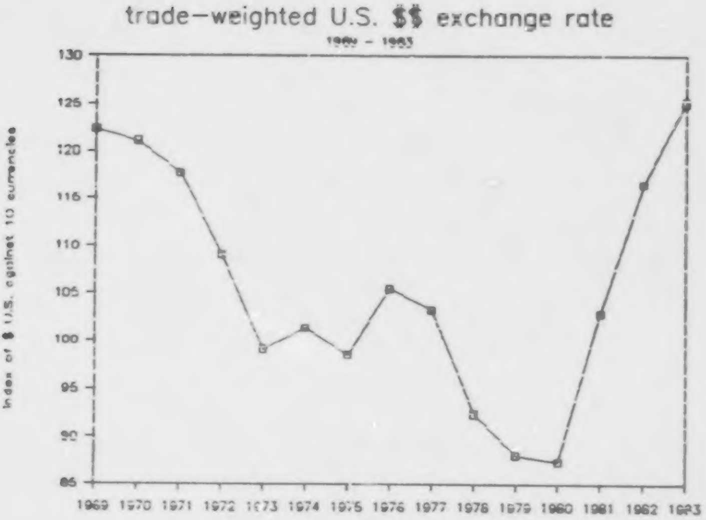
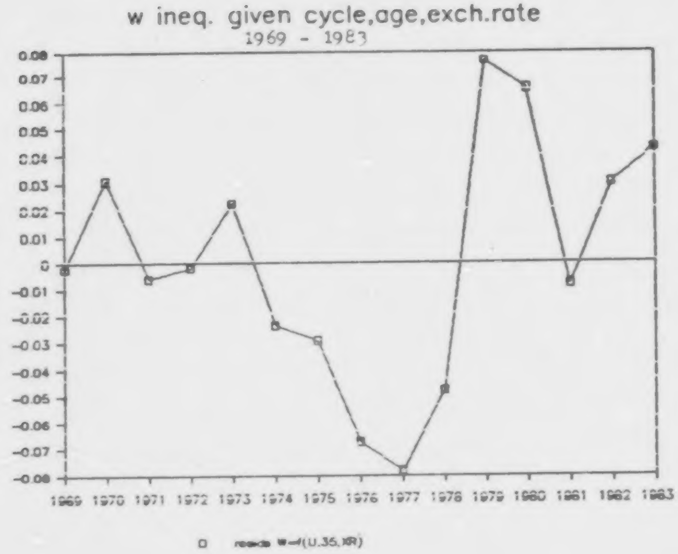

trade-weighted U.S. $$ exchange rate
1969 - 1983
Index of $ U.S. against 10 currencies
130
125
120
115
110
105
100
95
90
85
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. 8


w ineq. given cycle,age,exch.rate
1969 - 1983
actual–predicted var log wages
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
-0.01
-0.02
-0.03
-0.04
-0.05
-0.06
-0.07
-0.08
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
□ resids w=f(U,35,XR)

is even conceivable that *both* things are happening simultaneously, with a proportionate decline in the number of people earning middle-level wages ("the declining middle class" hypothesis that has been so much debated in the press since Robert Kuttner first broached the subject in 1983)..

Virtually all of the critics of Kuttner have tried to answer these questions by examining changes in the shares of total income (or wages, or earnings) going to the highest-paid twenty percent of the workforce or population, the next highest-paid twenty percent, etc. On this basis, there seems to have been very little change since the end of World War II in the relative size of the top, middle, and bottom of the income distribution (Belous, LeGrande, and Cashell). But how the shares of total income are being distributed is really *not* what most of us want to know. Rather, we want to know *how many* people have been earning "high", "middle", and "low" wages in each year, and how that has been changing over time. To do that, we need to analyze the shape of each year's income distribution against some *outside* standard of what constitutes high, middle, and low-wage income.

For that purpose, we are presently experimenting with the use of multiples of the official government poverty line for an unrelated individual under the age of 65, as the nearest approximation to an estimate of minimal income needs for individual workers. Thus, for example, in 1982 a person whose annual wages and salaries placed her or him in a range between two times the poverty line and seven times that benchmark would have been earning between $10,000 and $35,000 a year. The mean, median, and mode of the distribution of wage and salary incomes all fell within the $10,00-20,000 range in 1982, so our standard for defining adequate income seems quite sensible. At the upper end, with current costs of living and popular expectations about consumption, it would be difficult to consider wages below something like $35,000 to be indicative of great privilege.

We are therefore preparing tables on the number of workers falling below, within, and above this poverty-line-based definition of "middle-income persons". Of course, for all of our estimates of the share of the workforce made up of high-wage, middle-wage, and low-wage workers, we will test their sensitivity to these choices of exogenous income standards. In other words, how much difference would it make if the cutoffs were (say) two times and six times the poverty line? (roughly $10,000-$30,000 in 1982 dollars).

2.How much of the intertemporal dispersion in annual wages and salaries is variation among workers in the hourly or weekly wage rates of their jobs, and how much is variation in the number of hours or weeks they work each year?

A number of labor economists, most notably James Medoff, have argued that the personal distribution of hourly wage rates has remain virtually unchanged since the late 1960s, implying that there has been little or no change in the job structure. Instead, it is suggested, virtually all of the year to year variation in annual wages (or earnings) is attributable to differences among people in work experience: hours and weeks of paid employment over the course of the year. This may well be so--although no one to our knowledge has conclusively proven it by formally decomposing variance in annual labor income into variance in weeks or hours of work, on the one hand, and variance in weekly or hourly wage rates, on the other. This is an analysis we intend to perform this Spring.

But even if the assertion were correct, this need not imply that the job structure has remained unchanged. Under the pressure to show higher short-term profits, some personnel managers may be deliberately transforming jobs with full-time work schedules into positions that are staffed on a part-time basis, at more or less unchanging hourly wage rates (possibly in order to economize on fringe benefits). Alternatively, the outsourcing of tasks that used to be performed by unionized workers in large firms (whether auto plants or big-city hospitals) may plausibly be resulting in the relative growth of less-than-year-round work--even if the hourly rate of pay hasn't changed much. In any case, even in the absence of such practices, since different industries are characterized by a different mix of full- and part-time (or part-year) jobs (e.g. department stores vs. steel mills), any significant shift in industry mix over time could produce an aggregate change in the ratio of full- to part-time (or part-year) work opportunities. All of this needs to be explored.

3. To what extent are income inequalities appearing within the Black community that mirror those which we find for the population as a whole?

Under the theme of "the declining significance of race", such prominent black social scientists as William Julius Wilson have argued that racial discrimination *per se* has become less consequential for the Black experience in contemporary America than growing class disparities within the community itself. Certainly much public policy over the last fifteen years has been explicitly devoted to encouraging the development of a Black bourgeoisie in the U.S. At the same time, there has been a significant growth in the proportion of all Black children growing up in poor, fatherless households. While there are competing explanations for (and heated debates about the causes and implications of) this phenomenon, no one denies its importance as a major social issue.

And yet no one seems to have subjected the hypothesis of growing intraracial income polarization to rigorous quantitative scrutiny. We strongly suspect that the alleged growth of a Black middle class has been greatly exaggerated, and that Black people in this country continue to share much more in common with one another in relation to the principal institutions of the society--work, government entitlements, and treatment under the law--than is true for whites.

There are two other areas of inquiry which we intend to explore:

4. What are the implications of growing wage inequality (and especially of the hypothesized relative increase in the supply of low-wage jobs) for family work effort? That is, are more family members having to work more hours or weeks in order to achieve the same level of real family income from labor as before the great U-turn?

5. Among which industries and sectors (such as high-tech) is the tendency toward increasing wage inequality visible? On the other hand, which industries and sectors show declining inequality over time, even into the 1980's?

Once we have answered these questions, we should have a rather complete description of the anatomy of contemporary wage inequality. We will then be in a position to explore alternative explanations for why progress toward greater income equality among American workers has been so dramatically arrested within the last ten years.

IV. Postscript

It now seems fairly clear that both family income and individual wages and salaries are being distributed more and more unequally among the working people of the United States. There is still much to learn about the causes, precise magnitudes, and possible political-economic consequences of this development. Nevertheless, even with what we already know, two striking ironies become apparent.

Since the 1960s, the very mention of the word "inequality" has tended to raise images of the Black inner city ghetto (or of the desperately poor rural hollow). In both the popular media and political forums "inequality" has for all practical purposes been the study of the poor. The new research on inequality suggests that this comfortable notion has become outmoded. The sense of relative deprivation, of frustrated expectations, of falling behind, of being badly-paid—this is becoming the common experience of a growing number of Americans. They are white as well as persons of color. They are men as well as women. Having a full-time, year-round job is no longer a guarantee of being sheltered from this experience.

The second irony has even more far-reaching implications. It was in 1954 that Nobel laureate Simon Kuznets first proposed that income inequality tendn to increase during the early stages of economic development, then levels off and diminishes as development proceeds. Economic historians and other social scientists have for a generation taken the "Kuznets curve" as an article of faith. The long gradual movement toward greater equality within the developed industrial countries has been held out to the workers and farmers of the Third World as the eventual payoff to current sacrifices in the process of transcending "underdevelopment". Surely the perception that the long-run tendency toward greater equality in the U.S. may have been arrested can be expected to undermine the legitimacy of existing strategies of economic development throughout the developing world.

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Fig. A1

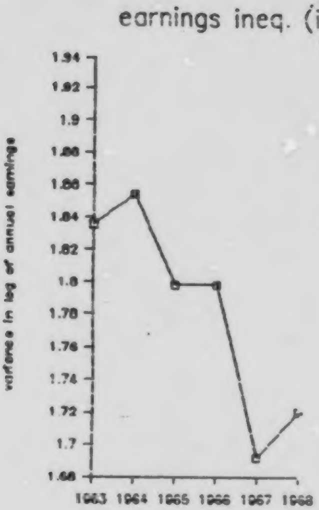

earnings ineq. (includes self-emp inc.)
1963 - 1968
variance in log of annual earnings
1.94
1.92
1.9
1.88
1.86
1.84
1.82
1.8
1.78
1.76
1.74
1.72
1.7
1.68
1963
1964
1965
1966
1967
1968

Fig. A2

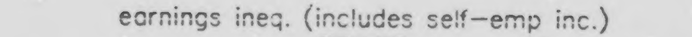

earnings ineq. (includes self-emp inc.)
1969 - 1983
variance in log of annual earnings
2.2
2.15
2.1
2.05
2
1.95
1.9
1.85
1.8
1.75
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. A3

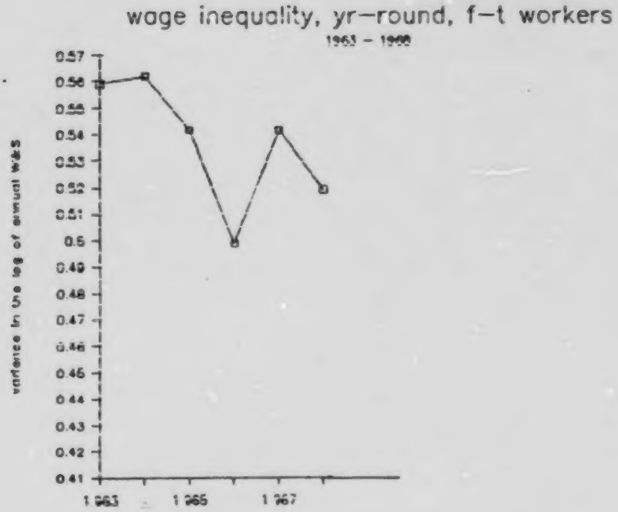

wage inequality, yr—round, f—t workers
1963 – 1968
variance in the log of annual w&s
0.57
0.56
0.55
0.54
0.53
0.52
0.51
0.5
0.49
0.48
0.47
0.46
0.45
0.44
0.43
0.42
0.41
1963
1965
1967

Fig. A4

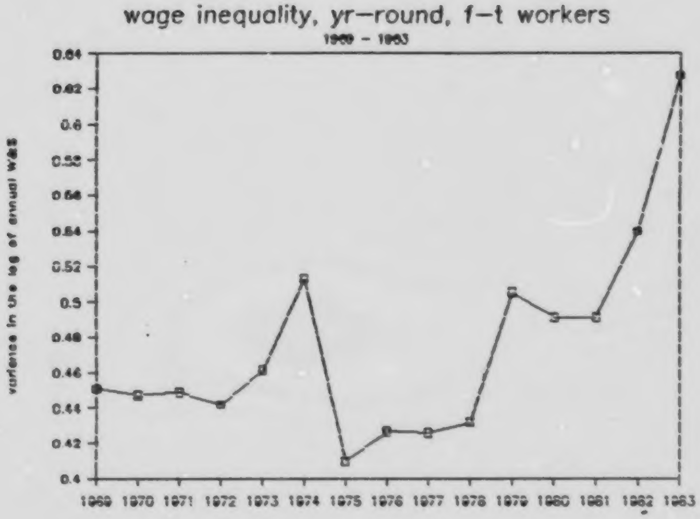

wage inequality, yr—round, f—t workers
1969 – 1983
variance in the log of annual w&s
0.64
0.62
0.6
0.58
0.56
0.54
0.52
0.5
0.48
0.46
0.44
0.42
0.4
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. A5

wage inequality — men

1969 – 1983

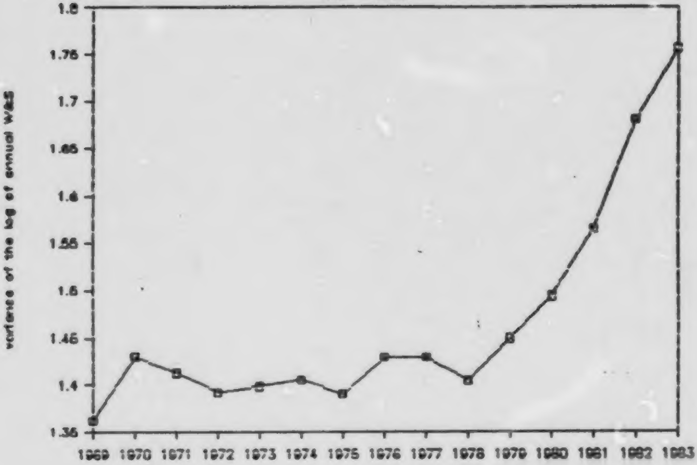


Fig. A6

wage inequality — women

1969 – 1983

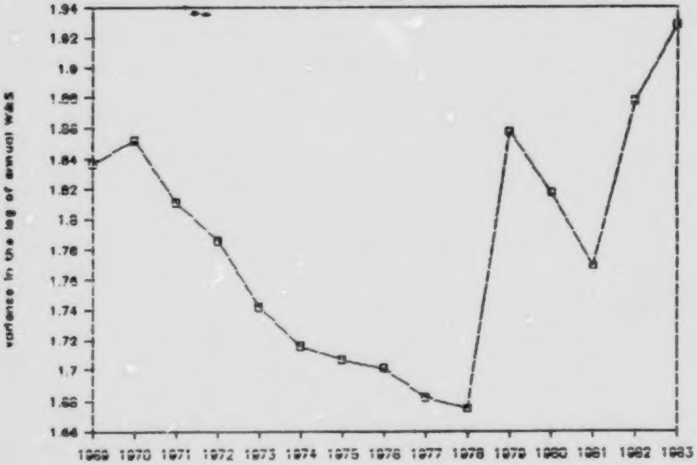


Fig. A7

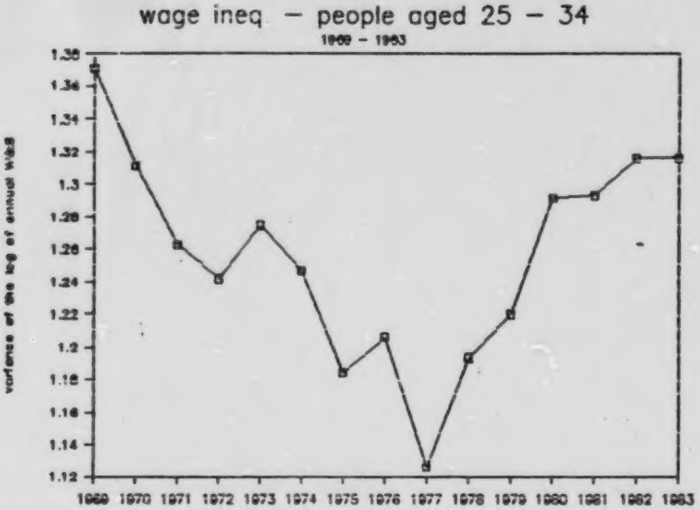

wage ineq - people aged 25 - 34
1969 - 1983
variance of the log of annual w&s
1.38
1.36
1.34
1.32
1.3
1.28
1.26
1.24
1.22
1.2
1.18
1.16
1.14
1.12
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. A8

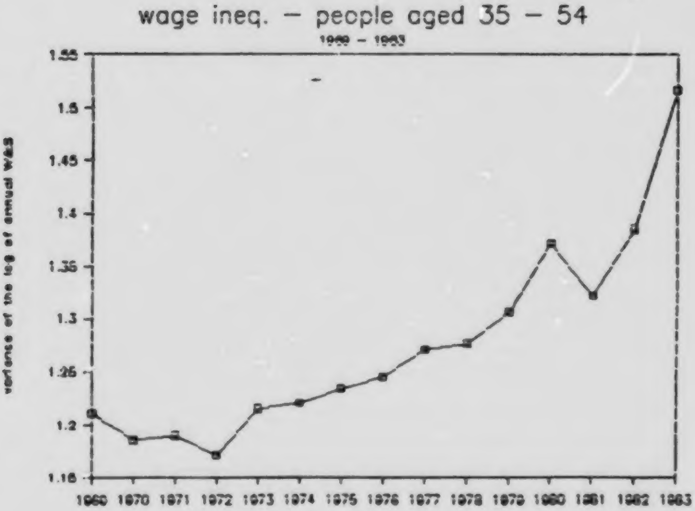
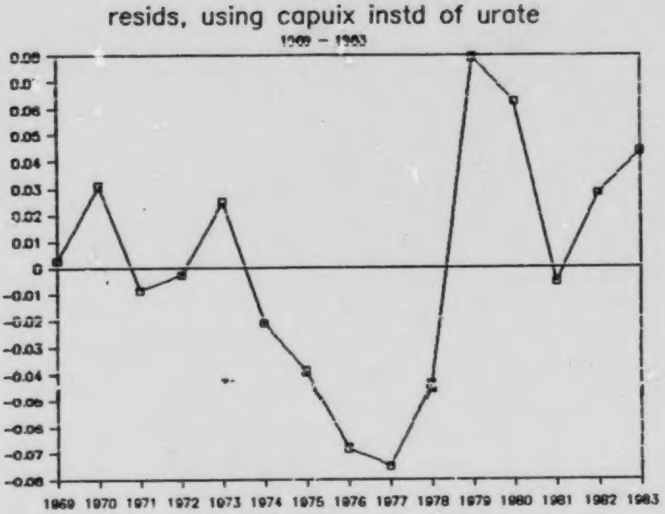

wage ineq. - people aged 35 - 54
1969 - 1983
variance of the log of annual w&s
1.55
1.5
1.45
1.4
1.35
1.3
1.25
1.2
1.15
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Fig. A9


resids, using capuix instd of urate
1969 – 1983
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
-0.01
-0.02
-0.03
-0.04
-0.05
-0.06
-0.07
-0.08
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983

Appendix Table A1

Regressions of Variance of Log Real Annual Wages and Salaries (t-statistics in parentheses)

Equation no.	(1)	(2)	(3)	(4)
Constant	1.699	2.094	.690	.829
Unemployment rate	.014 (1.39)	.028 (2.12)	-.005 (0.26)	
FRB capacity utilization index				-.002 (0.01)
Pct. of labor force under age 35		-1.020 (1.54)	1.207 (1.13)	.954 (1.52)
Trade-weighted exch. rate index (1973=100)			.005 (2.44)	.005 (2.73)
R-bar squared	.063	.152	.340	.342
N	15	15	15	15

Appendix Table A2

Spline Regression of Residuals from the Equation
Var Log Real W&S = f(URATE, PCT(35,XCHANGE)
(t-statistics in parentheses)

Equation	(1)	(2)
Constant	-.018	.027
Time	.002 (.82)	-.008 (1.79)
Spline (1978=1)		.025 (2.71)
Sum of squared residuals	.027	.017
N	15	15

rate of change for 1969-77 = -.008
rate of change for 1978-83 = +.025
H_0: [(SSR(1) - SSR(2)]/[SSR(2)/12] < F(1,12)
F(1,12) at the .05 level = 4.54
7.33 > 4.54
therefore the knot at 1977 is statistically significant at a 95% level of confidence

Ms. POVICH. Thank you very much.

I would like to remind our audience that we will be taking questions and if questions occur to you during any of the speeches by the panelists, please raise your hand and a member of the staff will come around and give you a card to write the question on and then we will be posting these questions to the panelists later.

Our second panelist is Marvin Kosters, who is a resident scholar and director at the center for the study of Government regulation at the American Enterprise Institute. He has also served as Deputy Assistant to the President for Economic Affairs, Associate Director for Economic Policy of the Cost-of-Living Council, and in the Manpower Administration of the Department of Labor.

PRESENTATION OF MARVIN H. KOSTERS

Mr. KOSTERS. Thank you.

Let me make some brief comments based on my paper on labor market flexibility.

The main thrust of my comments will be three points: That changing job patterns in the U.S. economy have been consistent with real income growth; that job change has been an important feature of the U.S. economy permitting adjustments that leads to employment and income growth; and that, compared to major European countries, our labor market is more oriented toward the market and certainly for job creation our experience has been better.

First, a brief point on recent job changes and real incomes. It's often been suggested that one thing that has been happening in our economy is that high wage manufacturing jobs are gradually being replaced by low-paid service jobs, with the implication that real incomes are declining.

Now in terms of employment shares, this is a mechanism that has been at work. But a few points are important.

The effect of changing shares have been very small. The effect has been present throughout the post-war period, both when incomes rose a great deal and when they didn't. Real income growth has been the result of factors other than these shifting shares, and it seems to me that the implication is that efforts to prevent such shifts are not likely to improve real income growth.

The second point. Gross measures of job change in the U.S. economy show that there's tremendous movement of workers and jobs. Let me illustrate what I have in mind there.

Bluestone and Harrison, to quote a colleague here, in their book published in 1982 say: "Together, runaways, shutdowns, and permanent physical cutbacks may have cost the country as many as 38 million jobs." Now a number of that magnitude might be plausible as a measure of gross job changes, but if it's a measure of gross job changes, then we shouldn't view it as a cost to the country. It could not certainly be a measure of net job change; that is, we could not have had an additional 38 million people employed at that time in addition to the 101 million who were employed in 1982 because there weren't that many potential job holders in the relevant age categories.

This distinction between gross job change and net change in jobs is I think, very important. Growth in jobs and real incomes has always come with large gross job changes.

The key question it seems to me is not how much gross change is occurring at any point in time, and we've had great deal in recent years. Instead, the key questions are whether the labor market can adapt to change, and whether enough additional new jobs are created.

I think in this regard comparisons between the United States and the European labor markets are quite instructive. First of all, we have created some 20 million more jobs in the past 15 years. Europe has created practically none; 10 or 15 years ago, and even 5 or 6 years ago, our unemployment rates compared unfavorably with those in Europe. Now their unemployment rates are higher. This raises the question, how does flexibility in their labor market compare with ours? I look at three basic aspects of that question.

First of all, on the supply side. On the supply side, our policies do more to encourage employment, they do more to encourage taking a job in terms of the relevant alternatives to work than the European labor markets do. In terms of alternatives to work our replacement ratios are lower and our durations of support are shorter than theirs.

On the demand side, our policies also compare favorably with theirs in terms of encouraging hiring by employers. For one thing, in the United States it's much easier to terminate employees when demand is slack and workers are no longer needed, releasing them for work in other jobs, than it is in Europe. Consequently, employers in the United States are much more inclined to take on additional workers.

Finally, our markets are more competitive than those in Europe. They have become more competitive in recent years in part because of a move toward deregulation in a number of industries. They have also become more competitive in part because of strong import competition.

This I think is an important point, an important point that is also relevant for some other countries in the world. That is, price deregulation and more competition in the product market has made labor markets much more competitive. Microeconomic policies have had macroeconomic consequences.

In terms of wage flexibility and employment flexibility in the U.S. labor market, I think we've seen more of it during the past 3 or 4 years than we did previously. But we didn't achieve more flexibility because of major changes in our labor laws or in our arrangements concerning employment and hiring practices or wages generally. We achieved it instead primarily, it seems to me, because of developments on the price side of the market, which has introduced more competition also on the input side—into the labor market.

Finally, our institutions, especially collective bargaining, have I think made important contributions. Certainly unionized workers have been strongly affected during the recession and in recent years generally. However, I think it's fair to say that those markets have adapted quite well to changes and I believe that this is a tribute to the flexibility of our labor market institutions. Even though they have certainly come through a period of duress, unionized workers have adapted to change by modifying contracts, wage patterns, and work practices. Thank you.

[The complete presentation of Mr. Kosters follows:]

January, 1986

U.S. Labor Market Flexibility and Regulatory Policies

Marvin H. Kosters
American Enterprise Institute

Introduction

The formulation of economic policy in the United States has, in general, proceeded on the basis of an underlying presumption that primary reliance should be placed on the marketplace. In most instances, the market system is the central element in the overall mix of policies influencing resource allocation. To be sure, prices, returns, and resource allocation are importantly influenced by government regulatory and tax and subsidy policies, both for the economy as a whole and in particular industries. Yet, reallocation of resources in response to changing economic conditions, including reallocation of labor resources, has been influenced primarily by decisions in response to market incentives.

Several significant developments have contributed to heightened interest in recent years in U.S. labor market performance. First, the shifting employment share from goods producing to service producing industries has led many observers to question the desirability of such a shift in terms of the implications for workers' skills and wages, competitiveness in world markets, and other aspects of the national interest that are usually not very carefully specified. Indeed, these economic developments gave rise to considerable discussion at the political level about the need for and merit of an "industrial policy" to foster "reindustrialization", or at least mitigate the "deindustrialization" that was perceived to be underway.

A second development attracted interest from an international perspective. Although U.S. unemployment (along with Canada's) has historically been high, compared to Western European experience -- and it has risen gradually over successive business cycles since the 1960s -- unemployment in several European countries rose to rates exceeding those in the U.S. during the 1980s. Moreover, the context of these developments in unemployment was markedly different on the two sides of the Atlantic Ocean. In the U.S., employment growth was unusually strong and the fraction of the working-age population with jobs was rising to new record levels, while overall employment levels were stagnant in many European countries and for the Community as a whole and the fraction of the populace at work was slumping.

Finally, the dominant general policy thrust in the U.S. in the 1980s was generally perceived to be toward deregulation and increased reliance on the market system. Regulatory reform was embraced more strongly and visibly by the Reagan Administration than by previous administrations, and the criticisms and objections voiced by opponents helped to publicize the administration's stance and identify it in the public mind. This market-oriented policy stance attracted the curiosity, and often also the interest, of policy communities in other countries that faced serious employment problems.

In this essay I first discuss shifts in employment shares between broad industry sectors and examine the implications of changes in industry employment shares for workers' real earnings. I then discuss factors contributing to flexibility in the U.S. labor market in the context of the regulatory policy climate with some comparisons with policies in European countries.

Economic and Industrial Context

Recent trends in the U.S. economy indicate that a structural realignment is taking place, a shift from goods producing to service producing activities. The realignment has, however, occurred primarily in employment and not in output. Real output in goods producing industries as a share of GNP was nearly the same (about 46%) in 1984 as in 1973 (Table 1). The employment share, on the other hand, declined from 39.5 percent to 31.5 percent. More rapid productivity growth (as conventionally measured) in the goods producing industries accounted for this divergence between output and employment shares.

For manufacturing, the output share declined only slightly from 1973 to 1984, but the decline in the employment share was more pronounced -- 32.0 to 24.7 percent. Manufacturing employment, in fact, declined in absolute numbers over that same period -- by about 750 thousand workers out of 20 million employed earlier. Despite the cyclical recovery, manufacturing employment remained about 3/4 of a million workers below its 1973 level in mid-1985. Cyclical changes were, of course, occurring during the period, with manufacturing employment rising to 21 million in its peak year, 1979, declining to 18 million by the beginning of 1983, and rising again by about 1.5 million workers by mid-1985.

The net reduction in manufacturing employment of 3/4 million workers from 1973 to 1985 was heavily concentrated in a few industries. Three broad industry sectors had net declines totaling almost 1 million workers: automobiles (100,000), steel (300,000), and textiles and apparel (600,000). These data reflect a pronounced cyclical recovery by 1985 only in the automobile industry. These developments in manufacturing stand out in strong contrast to the rise in total private nonfarm employment of more than 18 million workers over that same period.

This concentration of job losses in manufacturing is borne out by data from a special survey taken by the Bureau of Labor Statistics in January 1984 that was designed to identify workers permanently separated from their jobs, "dislocated" or "displaced" workers.[1/] The data collected in this survey provide measures of workers affected by plant closure, termination of their job, or slack work during the preceding 5 years, with primary attention focused on workers with at least 3 years of experience on the job that was lost.

These data show that out of the 5.1 million dislocated workers estimated by this survey, more than 50 percent of the jobs lost were in the manufacturing sector. This fraction can be compared with the 25 percent employment share and the 29 percent unemployment share accounted for by manufacturing. Dislocation was also concentrated disproportionately among relatively skilled and high-wage blue-collar workers and in industrial cities in the Great Lakes region.

Implications for Wages

In view of the disproportionate concentration of job losses in manufacturing industries, many of which were well known for their high wages, questions arose about the implications for wages and incomes of the structural realignment that was taking place. Concern was frequently expressed in the media that the restructuring toward service producing industries meant that highly-paid production jobs were generally being replaced by low-paid service jobs, with the result that the overall wage level for production workers would decline.

The validity of this concern seems to be borne out by simple, superficial comparisons. For example, correlations between industry wage levels and changes in employment (weighted by industry employment shares) are generally negative. This tendency toward declining employment shares in the relatively high wage industries is demonstrated for various periods in Table 2. The component of changes in average real wages (column a) that can be accounted for by changes in industry employment shares is reported in column b. The decline in real average hourly earnings (measured in 1979 dollars) of 30 cents from 1973 to 1979 is accounted for in part by the 8-cent decline attributed to the change in industry employment shares. That is, if industry employment shares in 1979 had instead been those that prevailed in 1973, and if industry average wages had been what they in fact were in 1979, then wages would have been 8 cents higher in 1979. It is in this sense that it is possible to say that employment changes from 1973 to 1979 had the effect of reducing overall average wages.

The share of the decline in real wages that is accounted for by changing employment shares between 1979 and 1984 is very similar to that in earlier years (11 cents out of 34 compared with 8 out of 30, as shown in Table 2). The effects of the recession are evident when that period is divided into the two sub-periods before and after 1982. Most of the decline in average wages that is attributed to employment shares came during the recession years when manufacturing employment declined sharply. And although real wages actually rose by 3 cents between 1982 and 1984, that increase occurred despite the small negative effect of changing employment shares.

It is clear from the last two lines in the table, first, that changing employment shares have had a negative effect on overall average hourly earnings for the past two decades (as well as in earlier years for which industry data are available in less detail). Second, it is apparent that changes in overall real average hourly earnings are primarily affected by factors other than changes in industry employment shares. Real average hourly earnings increased by 83 cents during the period 1964-1973 and then declined by 24 cents by 1979, even though the effects of changing employment shares were closely comparable for both periods.

The main component of changes in real average hourly earnings trends has been attributable to other factors (reflected in column c). Changing productivity growth trends have been the principal underlying influence on the difference between nominal wage increases and price increases that is reflected in real average hourly earnings measures. The effects of the changing demographic composition of the work force (described in Table 3) are also among the "other factors" influencing real average hourly earnings trends, along with changes in the schooling and skills of workers and the capital and technology that are available to them. Finally, it is important to note that these real wage comparisons were made for wages and employment of production and nonsupervisory workers only; they do not take into account changes in the shares or wages of that part of the work force accounted for by more highly paid professional and managerial workers.

The evidence on changing industry employment patterns confirms the impression highlighted by recent experience that shifting employment shares, taken by themselves, have had the effect of reducing overall average wages compared to what might otherwise have been realized. The evidence also clearly shows that this is not a new phenomenon; this trend has been present for at least the past thirty years. Moreover, the evidence indicates that only a relatively small part of actual real wage changes can be attributed to shifts in employment shares, and that over periods of several years, changes in real wages are predominantly attributable to other factors.

Although these data indicate that the computed effects of changes in industry employment shares have been reductions in a production worker wage index, the direction of causation may be the opposite of that suggested by the computation. That is, high industry wages may lead to job loss or discourage employment growth if industries are uncompetitive because of high labor costs. In any event, the employment mix has not been the key to real wage growth. Thus efforts to protect high wage jobs could be expected to contribute little, even in the short term, to higher average real wages, while the rigidities introduced by such efforts would inhibit the adjustments necessary to make these workers available for profitable new jobs and they would discourage the productivity-raising adjustments that have been the primary source of rising real incomes.

Demographic Context

Although the predominant demographic trends in the U.S. economy are quite well known, it is worth discussing briefly their magnitude. The main features to be discussed are the bulge in teenagers entering the work force during the past two decades, the sustained rise in labor force participation of women (and their diffusion into new occupations), the overall rise in labor force participation, and the rise in the share of the working-age population employed.

The fraction the labor force accounted for by teenagers rose rapidly in the United States in the early 1960s, rising from 7 to about 8 percent from 1960 to 1965 (Table 3). During the 1970s, teenagers rose to a peak fraction of the work force of 9.6 percent in 1974, with the percentage exceeding 9 percent from 1972 through 1979. By 1984, however, teenagers had returned to 7 percent of the labor force. The fraction of the work force accounted for by women, in contrast, has risen steadily throughout the postwar period, from about 30 percent in 1950 to 43.8 percent in 1984. Labor force participation rates for women have also risen steadily -- from 34 percent to 54 percent over the past 35 years.

The rise in labor force participation of women has contributed importantly to both a rising overall labor force participation rate and a rising fraction of the working age population employed. For several of the largest European countries, however, overall labor force participation has been quite stable or has declined during the past decade (Table 4). Stable or declining employment to population ratios in many of these countries reflect these trends and recent increases in unemployment.

Labor Market Institutions

Two features of the U.S. labor market that distinguish it from European, and many other countries', labor markets are its decentralization and its low extent of unionization. These features may be related, and they have fostered a degree of internal domestic labor market competition significantly stronger than that apparently existing in many other countries.

Not only is the U.S. labor force only partially unionized, but the extent of unionism has declined in recent years.[2/] Less than 20 percent of the work force is accounted for by union members, and there are significant regional differences as well. Since more than 80 percent of the work force is not unionized, wages in many geographic areas and industries are essentially set in competitive markets, unaffected by union wage scales. Perhaps as a consequence, the evidence available does not indicate that union wage-setting has played an important role in setting overall wage levels.[3/] This may be an important reason why real wages seem to have adjusted more fully in the United States to levels consistent with employment growth than in many European countries.

Although unionization has declined in the U.S., from nearly 30 percent of the private sector work force in the mid-1950s to about 16 percent in the early 1980s, unions have also shown a considerable ability to adapt to changing conditions. This adjustment has in many respects been difficult -- significant employment declines in the more highly unionized manufacturing sector have taken place. Nevertheless, collective bargaining structures and practices have produced not only lower wage trends in response to recession and lower inflation, but also increased recognition of the need to modify work rules and to develop new bargaining approaches. Reassessment by major unions of a wide range of policies and practices that were established during the postwar period has received extensive public discussion. This seems to be a reflection of a recognition that their recent difficulties are not exclusively, or perhaps even primarily, a result of policies under an administration generally regarded as less sympathetic to some of their economic interests than earlier administrations, since recent declines in membership can be characterized as a continuation of earlier trends instead of a new departure.[4/]

Economy-wide Labor Market Flexibility

At the macro-economic level, persistent high unemployment and sluggish employment growth can be viewed as symptomatic of a failure of real wages to adjust to levels consistent with higher employment. Although relative wages out of line with productivity differences among industries could also be a contributing factor, adjustments toward lower overall real wages could be expected to stimulate increased employment. To gain insight into relationships between real wages and employment at the economy-wide level, measures of real wage levels and changes have sometimes been made, and the responsiveness of real wages in different countries to changing conditions examined.[5/]

Measures of real wage responsiveness of two different kinds are relevant. Comparisons of the responsiveness of nominal wage changes to price level changes can give insight into the potential effects of market slack over business cycles. Such changes can be regarded as movements along a response function. Adjustments in response to disturbances that are at least partially exogenous, such as imported materials prices or exchange rate changes, involve shifts in price/wage response functions. Sorting out the magnitude and types of responses to disturbances of different kinds poses a difficult empirical task, especially in view of the lags that are normally involved. In addition, historical response patterns may not remain unchanged in the face of experience under new and different economic circumstances.[6/]

The presumption that lower real labor costs would contribute to stronger employment conditions, although straightforward in theory, is not easily demonstrated in practice. The real wage trends reported in Table 5 can by themselves provide only limited insight into whether real wage levels are encouraging or discouraging employment growth. For example, Japan and Great Britain have had closely comparable changes in real wages since 1980. Factors such as productivity growth, relative costs of capital, and exchange rate changes are among the forces that determine whether prevailing real wage levels are warranted, or whether instead they are too high to support desired employment levels. Based on comparisons of their employment and unemployment performance (see Table 4), these and perhaps other conditions were sufficiently different to support healthy employment growth in Japan despite rising real wages, while in Great Britain real wages increased more rapidly than was consistent with growing employment.

The Overall Regulatory Climate

Before turning to regulatory and other policy developments with implications for job creation that are less indirect, it is useful to set the stage with a brief discussion of regulatory reform. Regulatory reform emerged as political movement about ten years ago during the Ford Administration. Its roots in academic research and applied policy analysis, of course go back considerably farther.[7/]

Several factors account for the rise of regulatory reform to the forefront of the national political agenda. The most immediate factor contributing to political interest in regulatory reform at the time was persistent inflation, which rose sharply during and after the first oil shock in late 1973.[8/] Attention had been called to the price-raising effects of government regulation by books such as Murray Weidenbaum's Government-Mandated Price Increases and other related research directed toward quantifying and placing a price tag on the effects of government regulatory policies.[9/] Efforts to reform regulation were viewed in this context as a potentially promising way to reduce inflationary pressures, and as an alternative or complement to demand restraint which at that time was viewed as disappointing in its effects and politically costly in terms of high unemployment.

Support at the conceptual level for cutting back regulation came from two kinds of analyses of regulatory performance. Analyses of economic regulation led to a growing concensus among researchers that in many traditionally regulated industries -- particularly in transportation -- prices, service, and entry would behave competitively if such regulation were largely removed. Reliance on the marketplace instead could be expected, according to these studies, to increase efficiency and reduce costs and prices. It is also possible that the cohesion of interest groups that provided political support for existing regulation was weakening for reasons not related to policy analyses. For example, large fuel price increases and productivity gains that tapered off after jet aircraft came into general use may have reduced the attractiveness to airlines of rate and route regulation.

Analyses of a different kind provided support for reform of social regulation -- health, safety, environment and antidiscrimination regulation. By the mid-1970s it was becoming clear (1) that the overall amount of resources being devoted to meeting regulatory goals was large and (2) that in many specific instances single-minded pursuit of narrow regulatory objectives led to costs incurred that were disproportionately large in relation to benefits. The promise of regulatory reform was that by moving toward better balance of benefits and costs in working toward regulatory goals, resources could be saved, costs cut, and inflationary cost pressures reduced. Political support for the general idea of regulatory reform in these areas was attracted in part because of a growing recognition of the high costs and a growing disillusionment with the intrusiveness, delays, and adverse side effects of aggressive pursuit of regulatory goals. Despite a degree of general support for regulatory reform in these areas, specific regulatory changes have remained highly controversial for a variety of reasons, and political concensus for social regulation policies has remained elusive.10/

Since the mid-1970s, significant regulatory change has occurred, especially in economic regulation. Most of the legislative change in transportation and energy occurred during the Carter Administration, although legislative proposals were drafted and discussed during the Ford Administration. The areas of regulation affected include: domestic airlines (1978), natural gas (1978), international air travel (1979), interest rates (1980), trucking (1980), railroads (1980), and household goods moving (1980). In general terms, the Reagan Administration has continued to wind down economic regulation. At the present time, most of the transportation sector has been effectively deregulated and energy price regulations have been removed or, in the case of natural gas, made far more flexible.[11/] In telephone communications and broadcasting additional competition has also been introduced.

For social regulation, the most important tool that has been applied is more effective management and application of policies to achieve better balance. There is a thread of continuity in these management efforts that extends from the Nixon Administration, through the Ford and Carter Administrations, to the Reagan Administration's more comprehensive and stringent application of requirements for weighing benefits and costs.[12/]

Perhaps even more significant for the private sector than the technical features of regulatory management, however, has been the change in public/private interactions in administering regulations. During the Reagan Administration, a serious effort was made to mitigate the adversarial character of relationships between federal regulators and the regulatees. Significant strides were made in reducing the federal role in regulating state and local government activity by grant consolidation and other policies designed to foster federalism. Although substantive changes in regulatory policies applied to the private sector were somewhat limited, efforts to reposition the stance of federal regulatory authorities to reduce confrontation achieved some success.

A change in the regulatory climate toward more cooperative and less adversarial relationships between regulators and regulatees is not easily documented. Often, however, these difficult to describe changes in attitudes and in how processes are administered can be more significant than technical changes in regulations. The Reagan Administration seems to have succeeded in influencing attitudes in the private sector by providing assurance that their views would be heard and their case considered seriously, partly by shifting emphasis from enforcement of technical violations and procedural requirements used to browbeat private sector firms toward an emphasis on how policies contribute to actually achieving regulatory goals. Through its approach and its rhetoric, attitudes toward regulatory policy generally have been shifted by the Reagan Administration. State governments, for example, have in recent years established liaison offices and publicized a willingness on the part of the state officials to discuss regulatory problems with firms that are affected.

Microeconomic Context of Regulation

Regulations that have reasonably direct effects on wage and employment decisions can conveniently be discussed in microeconomic terms. For organizing the discussion it is useful to distinguish between those regulatory policies that mainly affect supply, those that affect demand, and those that affect competition in the labor market. Each of the individual regulatory policies considered are likely to have only marginal effects on overall labor market outcomes, but taken together their influence on labor market performance could be very significant.

The Supply Side. For wage and salary employees, a job involves both the willingness of the employer to hire and the willingness of the worker to accept the terms and conditions of employment. For the self-employed, the role and responsibilities of the individual in "creating" a job stand out clearly, but this aspect of job creation often receives less attention than it deserves for wage and salary employees. The individual's role involves cultural attitudes that influence schooling and skill development activities and that shape performance at work, but decisions are also affected by government policies and regulations through their influence on incentives.

One important type of incentive influencing workers' willingness to take jobs involves income that would be received when an alternative to work is chosen. The principal source for such income in the U.S. economy is unemployment compensation, although other sources such as disability payments are sometimes relevant and still other programs have at times been significant. One important dimension of such income payments is their size, which when compared to the employment alternative is usually referred to as the "replacement ratio".

For unemployment compensation, the replacement ratio in the United States has recently been well below 50 percent for the typical production worker. This is a lower ratio than has been available in the past when payments under the Trade Adjustment Assistance program were available in addition. The replacement ratio for the combined programs could often exceed unity prior to 1982 after taxes were taken into account. Also, private supplementary unemployment benefits are now less frequently available, and they are now administered in a way that raises the replacement ratio less than in the past. The effects of taxes on the after-tax replacement ratio are particularly important for households with more than one earner, but tax effects have been mitigated in recent years by both tax schedule changes and by the income threshold above which unemployment compensation is subject to the individual income tax. Replacement ratios in the U.S. are considerably lower than those in many European countries, where they are often on the order of two-thirds of previous wages. Several changes in U.S. programs have contributed toward generally lower after tax replacement ratios than prevailed earlier.

The Trade Adjustment Assistance program is a graphic example of retrenchment from policies that came to be regarded as excessively generous and costly. After it was liberalized in the mid-1970s, this program grew to become very significant by 1980, both in terms of numbers of workers and expenditures. At that point over half a million workers were receiving funds and expenditures totaling $1.6 billion. At their peak, outlays per worker reached about $5,000. Although this is roughly comparable to average outlays per worker on the insured unemployment rolls, many of the workers receiving Trade Adjustment Assistance payments were also receiving unemployment insurance payments. Changes introduced in 1981 limited assistance under the program to income support payments only as a continuation of basic unemployment insurance benefits, no higher than these benefits (limited to a maximum of 70% of previous wage), and only up to a year of unemployment insurance and Trade Adjustment Assistance combined.

Another important dimension of income from nonwork sources is the duration of their availability. At the present time duration of unemployment compensation payments is limited to 26 weeks for virtually all workers. This is a considerable reduction from duration of eligibility in earlier years, when at its peak up to 65 weeks were available. Moreover, Trade Adjustment Assistance, which had become increasingly important prior to the tightening of eligibility requirements and payments formulas, often made payments for up to 2 years available. After unemployment compensation is exhausted, workers and their families typically need to step down to income-conditioned programs, such as food stamps. These limitations on duration are quite stringent compared to programs in some European countries with essentially open-ended duration. Both in terms of replacement rates and duration, there has been a significant retrenchment in U.S. policies, spurred in part by increased recognition of the adverse incentive effects of more generous policies.

Another characteristic of the U.S. labor market affecting supply is the high degree of mobility of workers. Aspects of mobility include: geographic moves, job changes, occupation changes, and changes in labor force status. Geographic moves are common for American workers; in the early 1980s almost 6 percent of the civilian labor force had moved to a different county from the preceding year and about 20 percent of the labor force had moved since 5 years earlier. Among dislocated workers in the BLS survey -- workers affected by plant closure, abolition of jobs, and the like -- some 10 percent moved during the first year after losing their jobs and over 20 percent had moved by the time 4 or 5 years had passed.[13/]

One indication of frequency of job change is labor turnover rates in manufacturing. According to these data, some 4 percent of workers move on and off payrolls each month, with about half or more of these being voluntary moves in non-recession years. Another source of information on job change is the monthly unemployment survey. In 1984, for example, when the civilian unemployment rate was 7.5 percent and median duration of unemployment was about 8 weeks, about 10 percent of the unemployed had left their last jobs, about 25 percent were reentering the work force, almost 15 percent were new entrants, and the remaining 50 percent lost their jobs. These data indicate large flows between jobs, as well as into and out of employment and the labor force.

There is also substantial mobility across occupational categories. For the work force over 25 years old, 7.5 percent made an occupational change during the preceding year. This estimate, reported in Table 6, pertains to 1982-83, but similar data available periodically over the past 20 years show no major trends. Among the workers who made some type of occupational change, over 60 percent made a change sufficiently important to move them across broad occupational categories. Interestingly, the order of magnitude of these estimates is more or less comparable with similar data for a very different group, workers who were dislocated during the period 1979-84. Occupational mobility rates are higher for younger than for older workers; for 20-24 year-olds annual mobility rates are over 20 percent and for teenagers, in the 30 percent range. Even for experienced adult workers, however, some 4 percent apparently make a major occupational change in a typical year.

Many factors contribute to high geographic mobility. Housing is generally available in the marketplace; few jurisdictions have rent controls, and sale and repurchase of a residence is generally not subject to the individual income tax. No work permits of any kind are needed for citizens moving among states or cities. A common language is spoken, and while cultural differences are present, diversity and pluralism are prominent features of urban areas.

A quite different aspect of the supply side of the labor market involves possibilities for self-employment or starting a small business. For many kinds of businesses, requirements that need to be met to obtain permits are not entirely absent and business taxes are generally levied. Nevertheless, entry is feasible into most industries and activities, and deregulation in transportation and other industries has opened up possibilities that were previously essentially unavailable. It has been reported that new business formations since 1980 have increased twice as rapidly in deregulated industries as in the economy as a whole. While start-up capital is usually not easily raised, the relevant institutions and practices are widely available and utilized. For firms needing major infusions of capital, venture capital firms are always searching for promising business ideas.

The Demand Side. From the viewpoint of demand for labor, several broad classes of regulation have only indirect effects on employment in that their effects are similar to those of a tax on business activity. The costs of meeting environmental standards, for example, raise overall costs of engaging in production operations, but this would not necessarily have adverse effects on employment. To the extent that more stringent standards are applied for new production facilities, a common pattern in the U.S., expansion of production and output are of course discouraged. Since environmental regulations account for perhaps half of our overall regulatory costs, these effects became quite important by the mid-1970s.

Several factors have contributed to reducing the impact of regulatory costs of this kind in investment and production decisions. First, environmental regulation costs seem to have tapered off in the late 1970s after an initial major round of investments. Second, regulatory techniques were developed (such as "offsets" and "bubbles") to mitigate the long delays and frequent prohibitions on new plant construction. Third, heightened emphasis under the Reagan Administration on curbing costs and balancing them against benefits also contributed to lower regulatory costs.[14/]

Since 1981, the tax climate became much more favorable for making new investment. More favorable depreciation provisions, in particular, helped to offset the adverse effects of inflation and raise after-tax returns on investment. These tax changes contributed importantly to making the investment climate in the U.S. one of the most favorable in the world.

A factor more directly related to labor demand is non-wage costs of employment. The combination of supplementary benefits and taxes in the United States is apparently considerably lower than in virtually all European countries. According to data compiled by the U.S. Chamber of Commerce, benefit costs as a fraction of payrolls have been quite stable since about 1977. Legally required benefits (such as employers' share of social security taxes) have been about 9.5 percent of wages and salaries, and other social insurance payments (such as health and pension plans) have been in the 8 to 9 percent range. Taken together, these benefits have recently accounted for some 18 percent of wages and salaries. This is a considerable increase since 1960 when they accounted for close to 10 percent, or even since 1970 when they accounted for about 12 percent. The early and middle 1970s produced a very rapid increase in benefit costs, followed by considerable stability after 1977. Thus, costs of employing a worker in excess of those paid in wages have risen substantially over the years, but they have stabilized since the late 1970s at a rate much lower than in most European countries.

Termination of employment is apparently much more common and much less expensive in the U.S. than in Europe. Temporary layoffs, although not quite universal, are very widespread and generally accepted. Layoffs do, of course, have implications for unemployment insurance taxes paid, although the relationship is far weaker than would be justified on the basis of full experience rating. Permanent separation, moreover, can generally occur without redundancy payments, although many firms have made efforts to mitigate the impact of large permanent layoffs.

Costs in excess of direct wage payments are apparently lower in the United States than in European countries, both when workers are employed and when their employment is terminated. Since nationalized industries are virtually nonexistent in the U.S. economy, no major sectors are immunized from the ebb and flow of employment changes by being forced to retain employees that are essentially redundant. Although as a result of court actions, "employment at will" decisions are increasingly circumscribed, the main thrust has been to limit arbitrary dismissal rather than to erect barriers to employment separation.

Competition. The most pervasive effects of regulatory change on wage and labor cost flexibility are undoubtedly those brought about by the increased competition resulting from deregulation. Increased competition in the market for products or services is soon translated into increased competition in markets for inputs, including the labor market. Removal of price, service, and entry regulation opens the way to competition and cost cutting in several ways.

The deregulation of virtually the entire transportation sector in the U.S. in recent years provides experience on how competitive forces have operated. Competition among firms already in the industry to increase or maintain market shares led to efforts to reduce costs. These efforts included restructuring operations, such as regional hubs for airlines, as well as attempting to reduce input costs. Reducing labor costs took the form of changing its utilization and introducing flexibility into work rules and task assignments, as well as cutting back on wage and salary increases, and in some cases actually reducing wages. Competition also came from new entrants to the industry who were less constrained by old patterns, and whose employees either worked under newly established work rules or were not unionized. Competition between transportation modes became important in addition. All of these forces operated to improve efficiency and to cut costs or restrain cost increases. The effects of deregulation went beyond a one-time readjustment from prices set by regulation to prices at competitive levels; deregulation substituted continuously operating competitive markets for a regulatory structure with cartel-like, formula-based price setting.

The widespread wage cuts that occurred in the U.S. after 1979, many of them through renegotiation of the terms of existing contracts, partly reflected the increased competition that came with deregulation.[15/] Other forces were, of course, also at work, in particular strong import competition in industries such as automobiles and steel. Nevertheless, transportation deregulation was an important force that contributed to wage flexibility, more flexible and restructured work rules, and other new developments such as management disclosure of more detailed information for bargaining and the introduction of "two-tier" wage arrangements. These arrangements, which provide for a lower wage scale for newly hired workers than for those already employed, are an effective, if perhaps only temporary, solution to the problem of cutting labor costs while avoiding actual reductions in wages for workers already employed.

In certain instances, wages set administratively through regulation have prevented adjustments to competitive wage levels. The most significant of these situations is the minimum wage. However, the real level of the minimum wage, which was most recently raised in 1981 under legislation in 1977, has been eroded significantly. By early 1985, the minimum wage was about 37 percent of straight-time average hourly earnings in manufacturing, its lowest relative level since the 1950s and a considerable reduction from levels in the 50 percent range in the 1960s and 1970s immediately after minimum wage increases. Although special youth differentials have been proposed by the Reagan administration for minimum wages, Congress has shown no inclination to enact such a change.[16/]

Wage floors for private sector firms working under government contracts or funding are also established under the Service Contracts Act and the Davis-Bacon Act. The Davis-Bacon Act, requiring payment of "prevailing" wages in construction, is by far the most important. The prevailing wage requirement frequently resulted in wage floors for federal or federally assisted construction set at union scales that were higher than wages typically paid for comparable projects in local labor markets. Union work rules and only limited use of apprentices and low skilled workers also operated to increase costs and reduce employment opportunities.[17/] The effects of the Davis-Bacon Act have been mitigated in recent years by two developments, the growing share of non-union construction activity and changes introduced by the Reagan Administration in the way the Act is administered.

Although the more direct effects of regulatory programs are usually more easily identified and analyzed, the indirect effects on competition, on efficiency, on commercial opportunities, and on incentives are more pervasive and may be more significant for job creation. For example, regulations that raise the costs and difficulties of terminating employees may preserve some existing jobs, but they also raise costs to consumers, discourage hiring new employees in an uncertain economic environment, and impede the release of labor for use in other potentially more productive employment. Economic regulation based on rate of return formulas blunts incentives to improve efficiency by introducing innovation and purchasing lower cost or more productive inputs. Weak incentives and the costly and time consuming procedures for approval of new producers or new inputs or processes that usually characterize heavily regulated industries mean that successful marketing depends on factors other than commercial or economic value. The driving force behind private sector job creation is the potential for commercial success from taking advantage of economic opportunities. Signaling where such opportunities may lie, producing incentives to take advantage of them, and providing the mechanisms that facilitate production and marketing are processes that have been more effectively achieved under reliance on markets than under detailed regulation in the U.S. experience.

Concluding Discussion

The main theme that has been explored in this paper is flexibility for adjustments in the labor market. In the first part of the paper this flexibility is discussed in the context of industry employment changes, demographic changes in the work force, and labor market institutions. Changes in the regulatory climate are discussed in the second part of the paper in terms of their implications for the supply and demand sides of the market and for competition.

The main emphasis in the discussion is on how regulatory policy and labor market institutions are structured to accommodate change in a changing market environment. Government policies have in recent years in many areas moved toward more reliance on the market as the primary institution through which changes are stimulated and achieved. The data on U.S. programs and policies suggest that many have been structured to limit the diminution of market incentives that is the unavoidable side effect of most government regulatory and social policies. And for some industries, regulation has been reformed or removed to a degree that has greatly enlarged the scope for competition in the marketplace.

The pervasiveness of change in the economy as a whole, as well as within the labor market itself, is clearly evident in the data presented. Much of the change involves shifts among industries and jobs, with gross flows that are large in relation to net changes that occur. These flows involve destruction of jobs on a scale that is almost comparable in magnitude to the scale on which new jobs have been created. The incentives that are at work and the flexibility for change that has been demonstrated by the data do not by themselves indicate why healthy employment growth should be the net result. The underlying premise of the discussion however, is that the overall flow of change and the incentives that encourage changes are not entirely aimless or without any organizing principles. The main implication to be drawn is that strengthening incentives and allowing broad scope for change can be a successful strategy for achieving both employment growth and higher real incomes; policies designed to inhibit change, on the other hand, can reduce the potential for growth in productivity and real incomes without achieving the desired goal of maintaining employment or producing overall job growth.

Footnotes

1. Paul O. Flaim and Ellen Sehgal, "Displaced workers of 1979-1983: how well have they fared?", Monthly Labor Review, January 1985, pp. 3-16.

2. Marvin Kosters, "Disinflation in the Labor Market," in William Fellner, ed., Contemporary Economic Problems 1983-1984 (Washington, D.C.: American Enterprise Institute, 1984).

3. Marvin Kosters, "Wage Standards and Interdependence of Wages in the Labor Market," in William Fellner, ed., Contemporary Economic Problems 1979 (Washington D.C.: American Enterprise Institute, 1979).

4. Many aspects of unionism and the labor market in general are discussed in Richard B. Freeman and James L. Medoff, What Do Unions Do? (New York: Basic Books, 1984).

5. See, for example, Robert J. Gordon, "Wage-Price Dynamics and the Natural Rate of Unemployment in Eight large Industrialized Nations," OECD Workshop on Price Dynamics and Economic Policy, September 1984.

6. There is some evidence that labor costs (and prices) have shown more responsiveness to economic slack in the 1980-82 recession than in earlier recessions. See William Fellner and Philip Cagan, "The Cost of Disinflation, Credibility, and the Deceleration of Wages 1982-1983," in William Fellner, ed., Contemporary Economic Problems 1983-1984 (Washington, D.C.: American Enterprise Institute, 1984).

7. For an excellent review of insights from economic research, see Paul L. Joskow and Roger C. Noll, "Regulation in Theory and Practice: An Overview" in Gary Fromm, ed., Studies in Public Regulation (Cambridge, Mass.: The MIT Press, 1981), pp. 1-65.

8. See, for example, George C. Eads and Michael Fix, Relief or Reform? (Washington, D.C.: The Urban Institute, 1984), pp. 50-51.

9. Murray Weidenbaum, Government-Mandated Price Increases: A Neglected Aspect of Inflation (Washington D.C., American Enterprise Institute, 1975). See also, Murray Weidenbaum, "On Estimating Regulatory Costs," Regulation, May/June 1978, and Marvin H. Kosters, "Counting the Costs: The Business Roundtable Study," Regulation, July/August 1979.

10. For a wide-ranging discussion of the various approaches to reform that have received attention, see Clark, Kosters, and Miller, eds., Reforming Regulation (Washington, D.C.: American Enterprise Institute, 1980).

11. See Roger G. Noll and Bruce M. Owen, The Political Economy of Deregulation: Interest Groups in the Regulatory Process (Washington, D.C.: American Enterprise Institute, 1983), for a discussion of several areas of economic deregulation.

12. For a discussion of regulatory reform under the Ford, Carter, and Reagan administrations, see James C. Miller III, "Lessons of the Economic Impact Statement Program," Regulation, July/August 1977, David Gergen, "Will Carter Put Out the Fire?", Regulation, September/October 1977, and George Eads, "Harnessing Regulation: The Evolving Role of White House Oversight," Regulation, May/June 1981.

13. Flaim and Sehgal, op. cit.

14. Gregory B. Christainsen and Robert H. Haveman, "The Reagan Administration's Regulatory Relief Effort: A Mid-term Assessment," in George C. Eads and Michael Fix, eds., The Reagan Regulatory Strategy: An Assessment (Washington, D.C.: The Urban Institute Press, 1984).

15. See Marvin Kosters, "Disinflation in the Labor Market," op. cit.

16. Simon Rottenberg, ed., The Economics of Legal Minimum Wages (Washington, D.C.: American Enterprise Institute, 1981).

17. John P. Gould and George Bittlingmayer, The Economics of the Davis-Bacon Act: An Analysis of Prevailing-Wage Laws (Washington, D.C.: American Enterprise Institute, 1980).

Table 1

Employment and Output by Industry Group, 1973-1985

A. Employment and Output Shares by Broad Industry Group

Industry:	1973	1979	1984	1985
Goods-producing				
Total				
Output Share (%)	45.6	45.8	46.6	46.0
Employment Share (%)	39.5	35.8	31.5	30.8
Employment (000s)	24,893	26,461	24,730	25,010
Manufacturing				
Output Share (%)	25.9	24.8	23.9	n/a
Employment Share (%)	32.0	28.5	24.7	23.9
Employment (000s)	20,154	21,040	19,412	19,398
Service-producing				
Output Share (%)	43.3	45.3	45.0	45.2
Employment Share (%)	60.5	64.2	68.5	69.2
Employment (000s)	38,165	47,416	53,747	56,250
Private nonfarm				
Employment (000s)	63,058	73,876	78,477	81,260

B. Manufacturing Employment Changes (000s of workers)

Manufacturing	1973-79	1979-83	1973-85
Durable Goods	869	-1986	-351
Automobiles	14	-233	-93
Steel	-34	-227	-296
Other Durables	889	-1526	38
Nondurable Goods	18	-556	-373
Textiles & Apparel	-259	-282	-584
Other Nondurables	277	-274	211

Notes: Output shares are fractions of GNP in 1972 dollars. Output data for 1985 are for the second quarter, seasonally adjusted, and expressed at an annual rate. Employment shares are expressed as fractions of total private nonagricultural employment. Employment and employment shares are annual averages for 1973-1984. Employment data for 1985 are for June, and are seasonally adjusted in the top panel, but not in the final column of the bottom panel. Source for output data is Economic Report of the President, 1985, and Survey of Current Business, July 1985. Source for employment data is Bureau of Labor Statistics, Handbook of Labor Statistics, June 1985, and Employment and Earnings, various issues.

Table 2

Wage and Employment Changes: 1964-1984

Time Periods	Change in average wages (1979 dollars)	Component of wage change attributed to changes in employment shares	Component of wage change attributed to other factors
	a	b	c
1973-1979	-.30	-.08	-.22
1979-1984	-.34	-.11	-.23
1979-1982	-.37	-.09	-.28
1982-1984	.03	-.03	.06
1964-1973	.83	-.07	.90
1973-1979	-.24	-.06	-.18

The data in the columns are computed as follows, with $a = b + c$:

$a = w^t - w^{t-1}$ = change in average wages in 1979 dollars

$b = \sum_i (e_i^t - e_i^{t-1})\, w_i^t$, and

$c = \sum_i (w_i^t - w_i^{t-1})\, e_i^{t-1}$, where e_i and w_i are industry employment share and industry average wages (in 1979 dollars based on the Consumer Price Index), respectively.

Data for the four sub-periods at the top of the table are base on 56 2-digit SIC industries for which average hourly earnings and production worker employment are available. The data on the bottom two lines are based on the 49 of these industries for which such data are available to 1964.

Source: Bureau of Labor Statistics, Employment and Earnings, United States 1909-1984, Vols. I & II, (Bulletin 1312-12), and Supplement to Employment and Earnings, June 1985.

Table 3

Demographic Trends and the Workforce

	Percent of the Civilian Labor Force Accounted for by		Female Labor Force Participation Rate	Employment-Population Ratio
Year:	Teenagers	Women	(%)	(%)
1950	6.8	29.6	33.9	56.1
1955	6.3	31.5	35.8	56.7
1960	7.0	33.4	37.7	56.1
1965	7.9	35.2	39.3	56.2
1970	8.8	38.1	43.3	57.4
1971	8.9	38.2	43.4	56.6
1972	9.3	38.5	43.9	57.0
1973	9.5	38.9	44.7	57.8
1974	9.6	39.4	45.7	57.8
1975	9.5	40.0	46.3	56.1
1976	9.4	40.5	47.3	56.8
1977	9.4	41.0	48.4	57.9
1978	9.4	41.7	50.0	59.3
1979	9.2	42.1	50.9	59.9
1980	8.8	42.5	51.5	59.2
1981	8.3	43.0	52.1	59.0
1982	7.7	43.3	52.6	57.8
1983	7.3	43.5	52.9	57.9
1984	7.0	43.8	53.6	59.5
1985(2)	6.8	44.2	54.3	60.0

Source: Handbook of Labor Statistics, June 1985, Table 4, and Employment and Earnings, January 1985, Tables 1 and 3, and Employment and Earnings, August 1985, Tables 1 and 3. Data for second quarter of 1985 is seasonally adjusted.

Table 4

Employment, Unemployment Rates, and Employment-Population Ratio: 10 Countries, 1960-85

	U.S.	Canada	Australia	Japan	France	Germany	Great Britain	Italy	Netherlands	Sweden
Employment (millions)										
1975	85.8	9.3	5.9	51.5	20.7	25.2	24.0	19.5	4.6	4.1
1980	99.3	10.7	6.3	54.6	21.1	25.7	24.1	20.4	5.0	4.2
1981	100.4	11.0	6.4	55.1	20.9	25.5	23.2	20.5	5.0	4.2
1982	99.5	10.6	6.4	55.6	21.0	25.1	22.8	20.4	4.9	4.2
1983	100.8	10.7	6.3	56.6	20.8	24.6	22.6	20.5	4.9	4.2
1984	105.0	11.0	6.5	56.9	20.7	24.6	23.0	20.4	4.9	4.2
Employment - Population Ratio (%)										
1975	56.1	56.9	60.1	61.2	54.3	52.5	60.3	46.1	46.6	64.8
1980	59.2	59.3	58.4	61.3	53.1	51.6	58.9	46.1	46.9	65.6
1981	59.0	59.9	58.4	61.2	52.3	50.7	55.8	45.9	46.5	65.1
1982	57.8	57.0	57.3	61.2	51.9	49.4	54.6	45.2	45.4	64.7
1983	57.9	56.7	55.4	61.4	51.3	48.8	54.2	44.7	44.8	64.6
1984	59.5	57.4	56.0	61.0	50.6	48.9	54.6	44.8	44.5	64.9
Unemployment Rate (%)										
1960	5.5	6.5	1.6	1.7	1.6	1.1	2.0	3.2	-	1.7
1965	4.5	3.6	1.3	1.2	1.4	.3	2.0	3.0	-	1.2
1970	4.9	5.7	1.6	1.2	2.5	.5	2.0	2.8	-	1.5
1975	8.5	6.9	4.9	1.9	4.2	3.4	4.5	3.0	5.2	1.6
1980	7.1	7.5	6.1	2.0	6.4	2.9	6.8	3.9	6.2	2.0
1981	7.6	7.5	5.8	2.2	7.5	4.1	10.4	4.3	9.3	2.5
1982	9.7	11.0	7.2	2.4	8.4	5.9	11.8	4.8	11.3	3.1
1983	9.6	11.9	10.0	2.7	8.6	7.5	12.8	5.3	14.5	3.5
1984	7.5	11.3	9.0	2.8	10.1	7.8	13.0	5.6	15.0	3.1
1985*	7.3	10.6	-	2.6	10.5	8.0	13.3	5.6	-	3.0

* Second Quarter, 1985.

Source: Joyanna Moy, "Recent trends in unemployment and the labor force, 10 countries," Monthly Labor Review, August 1985, and Bureau of Labor Statistics, Statistical Supplement to International Comparisons of Unemployment (Bulletin 1979), September 1985.

Table 5

Real Wage Trends, 1965-1984

A. Real Hourly Earnings Index (1980 = 100)

Year	U.S.	Canada	Australia	Japan	France	Germany	Great Britain	Italy	Netherlands	Sweden
1965	86.1	73.8	73.1	42.5	52.6	64.7	70.6	n/a	71.0	61.3
1970	89.9	85.8	85.3	58.4	66.1	77.5	87.1	65.6	82.1	76.1
1971	91.3	90.1	90.1	63.7	69.6	79.8	88.5	68.6	85.3	76.3
1972	93.9	92.7	90.8	70.0	73.1	82.4	92.2	70.5	86.7	81.8
1973	94.9	92.5	91.4	74.2	77.5	85.4	97.7	77.6	91.4	82.4
1974	94.1	91.1	95.5	77.0	83.2	88.2	100.0	78.9	98.4	95.1
1975	94.2	95.1	97.1	84.2	86.0	89.7	99.6	85.9	99.2	95.4
1976	96.6	98.7	97.4	89.1	89.3	92.3	100.2	88.0	99.6	98.2
1977	99.4	101.8	98.8	92.2	92.4	95.4	97.0	94.3	100.7	98.3
1978	100.7	102.3	100.4	94.3	95.3	96.4	100.1	96.2	101.0	99.6
1979	100.5	100.9	99.6	97.3	97.5	98.0	100.8	98.9	101.5	101.1
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	100.3	101.3	102.2	102.3	100.2	101.3	101.6	104.7	97.4	100.7
1982	100.6	102.8	102.3	105.8	103.1	101.2	105.6	104.4	98.4	99.6
1983	100.7	100.9	101.3	109.3	104.5	101.2	108.8	105.0	99.9	98.2
1984	100.7	102.6	103.3	111.3	106.0	101.7	110.3	105.2	98.0	100.4

B. Average Annual Percentage Change in Real Hourly Earnings

Period	U.S.	Canada	Australia	Japan	France	Germany	Great Britain	Italy	Netherlands	Sweden
1973-79	1.0	1.5	1.4	4.6	3.9	2.3	0.5	4.1	1.8	3.5
1979-84	0.0	0.3	0.7	2.7	1.7	0.7	1.8	1.2	-0.7	-0.1

Source: International Monetary Fund, International Financial Statistics Yearbook, 1984, and OECD Main Economic Indicators, July 1985. Figures are computed from published indices of hourly earnings in manufacturing and the GNP deflator.

Table 6

Occupational Mobility Rates

	Percent of All Workers Changing Occupation		Percent of Job Changers Changing Major Occupation	
	All Changes	Major Changes	All Workers	Displaced Workers
Major Occupation Group	(1)	(2)	(3)	(4)
Executive and managerial	8.1	4.8	58.9	57.2
Professional specialty	5.3	2.9	55.6	53.0
Technicians and related	6.8	6.1	89.1	52.1
Sales occupations	9.7	6.5	67.0	45.8
Administrative support	8.6	4.4	51.6	46.8
Service occupations	7.4	5.3	71.6	50.6
Precision production	6.4	4.3	66.8	41.9
Machine operators	8.2	5.3	64.5	58.9
Transportation occupations	6.9	5.1	73.4	41.2
Handlers, helpers, and laborers	11.8	10.3	87.3	77.0
All occupations	7.5	4.8	63.4	51.1

Notes: The data in columns (1), (2), and (3) refer to all workers aged 25 and over who were employed in January 1982 and January 1983. The data for displaced workers in column (4) refer to individuals aged 20 and over who were permanently separated from a full-time private sector job between January 1979 and January 1984 and who were reemployed as of January 1984.

Column (1) gives the percentage of workers, classified by original major occupation, who reported an occupational change (possibly within the major occupational category) between January 1982 and January 1983. The percentage reporting a different major occupation category is given in column (2). Column (3) is the ratio of column (2) to column (1), and it gives the percentage of those workers changing occupation ("job changers") between 1982 and 1983 who also changed major occupational category.

Column (4) gives the percentage of all displaced workers, classified by major occupation in job lost, who changed their major occupation category in becoming reemployed. The mobility rates in this column differ slightly from columns (1) through (3) in that changes in occupation are over a period longer than one year.

Workers whose original major occupation group was farming, forestry, and fishing, or protective and private household service are excluded in all cases. Source: Ellen Sehgal, "Occupational mobility and job tenure in 1983," Monthly Labor Review, October 1984, and the BLS displaced workers microdata file.

Ms. Povich. Thank you very much.

Our next panelist is Prof. Michael Piore. Professor Piore is Mitsui Professor of Contemporary Technology at the Massachusetts Institute of Technology.

PRESENTATION OF MICHAEL J. PIORE

Mr. Piore. I guess I'd like to speak to the issue of flexibility too. My paper is directed to the issue of flexibility and in a certain sense I take completely the opposite view of my colleague, Marvin Kosters. I guess what I'd like to do is try briefly to lay out the point of view from which I am arguing and then to try and talk a little bit in the brief time available about how that point of view applies specifically to two aspects of labor market policy. One is wage policy and the second is a series of managerial reforms in the deployment of labor which have been encouraged by the kind of labor market policy which the administration has pursued.

The difficulty with flexibility which you could take either in the form in which it's been presented by the Reagan administration or the form in which it's presented mostly by the economics profession or the orthodox economics profession I think, is that the labor market is not a market in any conventional sense of the term. The labor market as we use the labor processes are embedded in a set of institutions and social structures and those institutions and social structures will not go away. They may be suspended for a short period of time but eventually all of history, European and American as well, suggests that some kind of social process is going to reassert control over the structures of the labor market.

And it is the transition from one set of social structures to another which, it seems to me, we ought to be concerned with and not with the idea of suspending those social structures altogether.

The difficulty with the administration's labor policy, it seems to me from my personal point of view, is not the particular constraints on which they focus. Some of the problems which they find in our labor market structures I find—that is, I'm not sure I agree on specific problems, but to a large extent, I think I do agree that the labor market structures that we have had in the past have been poorly adopted to the economic environment of the moment.

But the problem is how you are going to switch from the social structures of the past to some new set of social structures that are more compatible with an effective economic system in the future.

I think that the administration policy which has pushed us into a kind of free-fall in the labor market, if you will, is in the end going to get us into a lot of trouble. And I would like to suggest how that trouble is likely to emerge and where the traps are buried in a sense in two aspects of labor market policy.

One is wage policy and the other is the kind of drive toward economic efficiency.

In the post-war period, our wage determination system was governed by a set of Government regulations and collective bargaining rules that were extremely complex, but the essence of those rules, at least as they affected the rate of wage inflation, was the GM-UAW settlement of 1948 which basically linked the wages in that industry to a formula which was called the annual improvement factor based on the 3-percent historic productivity growth in the United States, plus the cost of living.

And other wage-setting institutions in this country were linked indirectly to that formula and the commitment to that formula throughout the 1970's when we did not have the kind of productivity rate which would make that rate of wage increase noninflationary, it was that kind of commitment which drove up the price level in the United States.

Now that formula has effectively been suspended and it is the suspension of that formula which is the proximate cause of the kind of wage and price stability that we've had in the American economy in the last 4 years.

But I ask you to look at the way in which that formula was suspended. That formula was suspended in an extremely loose labor market in a political atmosphere when labor was under tremendous amount of pressure. So that in a way the suspension was due to the weakness of the labor movement, but second of all, it was understood by labor leaders and explained to the rank and file in terms of a series of specific problems of American industry; namely, that our labor costs had, through a commitment to this formula in the past, gotten way out of hand and that in order to save jobs and revive the critical industries which were leading the wage inflation we had to lower our relative wage rate.

That was the way this formula was sold and it was on that basis that a series of compromises were made, but they were not compromises which in any sense committed people to a new and alternative system of wage rates. They were simply compromises with the existing formula and the existing formula is here. It remains in the collective bargaining agreements and it remains in the minds of the work force as a standard of what would be a fair and equitable wage settlement. It remains as a standard at a time in which the rationale for that formula no longer makes sense to anybody. It does not make sense to the labor leaders who accepted it. It does not make sense to management who pushed it, and it doesn't make sense to the rank and file.

It doesn't make sense because the problems of those industries were completely swamped in the last 4 years by variations in the value of the dollar and no amount of wage adjustment that one could conceive of would have saved the competitive position of those industries.

So we now have the formula sitting there where the rationale has gone away. The danger, I think, is that because the administration has not attempted to help the economy transfer to a new set of wage-setting mechanisms as we begin to reassert in the economy, as we surely will, a set of social structures which govern and channel labor relations, that formula is likely to come back. And if it does, it will bring us back to the inflation that we've had in the past.

Now I've used up most of my time on wages, but in a certain sense I think the larger problem is not so much wage inflation but the efficiency of American industry because in order to regain an effective position in international markets I think it is clear to both American labor and American management that a number of series of reforms have to be made in the way in which American industry goes about doing its business.

In a number of large companies in the United States those reforms are being introduced. Those reforms have to be seen as a package and they involve things like a reduction in process industries, reforms of engineering department which integrate process and product engineering, shifts to kind of matrix management and so on. They involve those kind of reforms as much or more so than they involve reforms in labor relations such as quality circles, profit sharing and so on. They involve managerial reforms which management finds difficult to make on its own terms, with or without labor pressure.

I think it's becoming increasingly clear to American management that it is those reforms in management, and not the reforms particularly in labor or the reforms in labor only as part of these larger managerial reforms, that are going to enable American industry to survive.

But in the short run, almost any American manufacturing or even service firm can go a very long way simply through cuts in labor costs. And the real danger in the United States I think is that faced with the problems of making these major reforms in the way in which business operates that American management will take the shortcut of reforms in labor. Reforms in labor may save a firm for a year or two, but it is not going to set the firm in a position to relaunch itself in the international marketplace.

Again, the administration, by focusing on labor costs and creating the illusion that you can drive down labor costs indefinitely through wage costs is distracting American industry, it seems to me, from basically the kinds of reforms which have to be made. Those reforms, just to repeat the final point, are a series of reforms which are going to give American management and American labor, if they're successful, a new social structure in which to operate.

And the notion of a free marketplace, the notion that you can impose a free marketplace without paying any attention to the social structure of labor and managerial processes is, I would submit to you, a kind of illusion that in the end is going to be extremely costly to the economy's ability to compete effectively and give to its citizens a rising standard of living as we move into the next century.

[The complete presentation of Mr. Piore follows:]

Economic Flexibility or Social Anarchy: A Critique of the Reagan Labor Policy

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This paper was prepared for the January 17, 1986 Symposium of the Joint Economic Committee of the United States Congress.

The hallmark of labor policy in the Reagan Administration has been the pursuit of what is called, somewhat euphemistically, "flexibility". The policy seeks to give much greater power to management to adjust the terms and conditions of employment to what managers perceive to be the requirements of the production process and the conditions of the market place. Its major thrust is to weaken, and ultimately eliminate, institutional restrains upon managerial policy imposed either by trade unions or by governmental regulations. The debate which this policy has engendered has, however, tends to confuse particular restrictions upon managerial freedom with the issue of regulation in general. This paper attempts to draw a sharp distinction between the two. It argues that while a number of changes are indeed required to adjust effectively to current economic conditions those changes will only be viable in the long run if they are accomplished through negotiated changes in government regulations and collectively bargained rules.

As background for this discussion, it is useful to recognize that we in the United States have a somewhat peculiar set of restrictions upon managerial freedom in the deployment of labor, particularly in blue collar manufacturing jobs. In essence, our regulatory system leaves management free to vary the level of employment by hires and lay-offs but the allocation of jobs among whatever numbers of workers the employer chooses to have is tightly constrained by a set of collectively bargained rules and government regulations known as the seniority system. These rules and regulations determine which members of the labor force will be laid off and how the remaining jobs will be allocated among those who are still employed. They also govern promotion and recall and have been extended in the pursuit of equal employment opportunity to new hires.

The operation of these rules requires that job assignments be unambiguously defined and this requirement in turn limits managerial freedom to allocate workers freely to the tasks at hand in response to the monentary requirements of the production process. We also tend to attach wages to job assignments; this means that wages of individuals move up and down flexibly when jobs are reallocated in cases of lay-off or technological change but it also puts further pressure on management to preserve the integrety of job definitions.

In most other industrial countries, managers have much greater freedom to assign work to individual employees as they deem necessary and to vary those work assignments to fit the requirements of the production process. But they do not have this freedom because they are unrestrained. Rather, the freedom exists because the nature of the restraints is different. In general, managers abroad are not free to lay-off workers in response to changing market conditions, and they must guarantee the worker a fixed wage rate whatever his or her current job assignment. American managers often admire foriegn managerial rights because they see only the freedom without recognizing the restrictions with which that "freedom" is purchased. Nontheless, it is true that many mangers believe that even with the "hidden" restrictions, the European and Japanese systems are more effective; that the U.S. system places us at a competitive disadvantage and has now become intolerably burdensome and must be eliminated.

In evaluating these claims two historical facts must be kept in mind. First, the particular structure of labor market regulation which is now being dismantled because it appears burdensome and restrictive, was deemed capatible with, even conducive to, economic growth and prosperity for the first three decades of the postwar period. If the structure is burdensome now, it is not because of the regulations *per se* but because the economic environment in which the structure operates has changed. Second, the existence of *some* structure of regulation is not peculiar to industrial societies at this particular historical juncture, but is indeed an almost universal and continuing feature of human existence. Historical instances of a completely unregulated labor market in which the wage and the level of employment varied freely in response to market conditions as in an abstract model of a competitive commodity market are rare or nonexistent. The closest the U.S. economy ever came to a labor market of this kind was from 1931 through 1933. That labor market was created by the wholesale abandonment, under pressure of the Great Depression, of the structure of employment and wage regulation which had existed in the 1920s. The structure which is under pressure for change today grew out of the spontaneous industrial union movement which sprang up in the late 1930s in reaction to what was widely viewed as the anarchy of the 1931-33 period. If that structure is, relative to others in the world, peculiarly inefficient it is because alternative institutional arrangements, much closer to those of present day Europe and Japan, which existed in the United States in the 1920s, were discredited by the fact that management abandoned them unilaterally in 1931 when workers were poorly organized and unemployment was high.

The experience of the Great Depression should lead us to ask whether what is viewed as flexibility by policy-makers and managers will not come to be perceived by the labor force as a kind of social anarchy and, if it does, whether it will prove to be a stable base upon which to build the nation's economic revival. Indeed, it leads me to wonder whether the practices and procedures which business needs to compete effectively in emergent world markets and which in and of themselves may be conducive to a healthy, productive, and even humane work environment, may not come to be foreclosed in the future because of the climate in which they are being introduced today -- a climate which I want to underscore is being created and maintained deliberately and consciously by the social policy of this administration.

This is the background against which the reality of labor market and industrial relations policy must be judged. I would like to discuss the implications of that reality in terms of two specific problems; one is the problem of wage inflation, the other is the problem of the productive efficiency of American industry. These are the two major problems which have concerned economic policy makers in the last decade. They are the problems which the policy of flexibility -- or as it may come to viewed, anarchy -- was designed to solve and, at least as far as wage inflation is concerned, apparently did solve.

Wage Determination and Inflation

The immediate cause of the wage inflation of the 1970s was the continued application of a series of wage setting rules embedded in established collective bargaining relationships and in nonunion employment practices by the threat of union organization. The rules were to a large extent implicit, and that and their immense complexity make it very difficult to spell them out in limited space, but their essence is conveyed by the formula which prevailed in the automobile industry. The automobile formula linked wage increases to an annual improvement factor of 3 per cent per annum plus a cost of living allowance. That formula was compatible with price stability in the 1950s and 1960s when 3 per cent represented roughly the long run rate of productivity increase for the economy as a whole. It was inflationary in the 1970s when productivity gains were closer to 1 per cent and the cost of living escalator had the effect of compounding the short fall of productivity. Prices in the American economy have stabilized in the last five years in very large measure because that formula has been suspended. The prospects for price stability in the future depend on the likelihood that the formula or something like it will be reinstated.

Conventional economic analysts ignore this formula. They do so for two rather different reasons. One group believes that the formula, and others like it, are imposed artificially by trade union and/or government regulation. If one can eliminate that regulation, wages will respond freely to market forces and the wage rate will automatically be noninflationary. This is presumably the rationale, at least in wage policy, of Reagan's effort to weaken the institutions of union and government regulation. The other view is that wages have always been responsive to market conditions and that what is lowering wage inflation now is the much higher levels of unemployment at which the economy is currently -- and is expected in the future to be -- operating. This latter view does not seem to have much to do with deregulation since it implies that the regulations were never very effective in the first place. The first view thus seems to dominate Administration policy. Of the two, it is clearly the more optimistic because it implies that once the perverse institutions have been eliminated, the economy will once again be able to operate at low levels of unemployment.

But one must ask whether Reagan will be successful in eliminating unions as the key wage setting institutions and if so whether the market will replace them. There are few large companies in the United States today where the question about union survival is not the subject of an active internal managerial debate, and even in strongly unionized companies there are now important managerial factions arguing for nonunion strategy. But I do not know of any manager who seriously believes that the alternative to a collectively bargained wage policy is a free response to the market. Most companies of any size believe that if they are to remain nonunion over the long run, they must have a reasoned set of wage setting rules to which they adhere faithfully and which they can explain and justify to their employees. If those rules are not the annual improvement factor plus the cost of living, one must ask what the alternative rules are going to be, because those rules, whatever they are, are going to determine the prospects for price stability.

From this point of view, what is disturbing is that the automobile rule has not gone away, nor have the wage setting structures linked indirectly to the automobile rule. And we have not generated a widely accepted alternative set of wage setting principles. Because the administration has pursued the notion of unrestrained managerial freedom in setting the wage rate, there has been no dialogue at all about what ought to govern wage movements. As a result, instead of being abandoned, the old principles of wage setting have merely been suspended. And indeed in many cases the gains which they would have yielded continue to be calculated and existing wage settlements compared to those gains with some expectation that the difference will eventually be made up. The old rules thus lurk very much in the background of existing wage setting procedures. To put it bluntly: present wage setting is in violation of a well understood and widely accepted set of social principles. Those principles may not have the status of law, but they command the respect and allegiance of law throughout much of American society.

A second factor, moreover, makes the continued violation of these social principles increasingly problematic. The rules were initially suspended because of a particular diagnosis of the problems of the American economy. That diagnosis was that labor costs in the United States had increased too rapidly in the 1970s and had placed American industry at a serious competitive disadvantage relative to our principal trading partners. First managers and subsequently union leaders came to believe that U.S. industry was no longer "world class" (to borrow a phrase from my colleague, Lester Thurow) and that the basic problem lay in our private labor codes, of which wage setting standards were an important component. With the help of the recession of 1981-82 and the example of the air traffic controllers, union leadership managed finally to convince the rank-and-file that this was the case, and that diagnosis provided the intellectual rationale for concession bargaining and the basic justification for the suspension of the prevailing wage setting rules.

The basic argument, however, is no longer really plausible. The impact of wage setting rules upon the competitive position of American industries has been completely swamped over the last four years by the appreciation of the dollar, and it is increasingly clear to everyone that the fate of American industry in international markets is being determined by whatever factors govern foreign exchange and not by labor costs at all. Moreover -- and this is a point to which I will return at some length below -- while American managers continue to believe that business practices in the United States are not compatible with a "world class" industry even at exchange rates which reflect something like purchasing power parity, they no longer believe that labor practices are the central, or even a central, part of the problem. This view is coming to be shared by union leaders and it too will filter down to the rank-and-file worker, not only in unionized establishments but outside the labor movement as well. As the rationale for suspending the old rules becomes increasingly less plausible, and without alternative standards of equity in wage setting, existing procedures are coming to seem increasingly arbitrary and anarchistic. The status quo may nevertheless prevail for a time, enforced by the harsh realities of high unemployment rates and aggressive anti-union management, but history does not suggest that it will go on indefinitely.

I have used the suspension of the automobile formula to illustrate the argument because I believe that it has been the most important institutional factor in the recent stabilization of wages, but I could have equally used two-tier wage structures as an illustration. These structures have been introduced as a way of lowering labor costs in response to competitive pressures, particularly in the airline industry. They violate the deeply held principle of equal pay for equal work, but they have been justified as a necessary transition to a deregulated industrial structure, a goal which is, at the moment anyway, widely viewed as desirable. Such structures have also been attractive to newly aggressive managements in the airlines because they tend to divide, and hence to weaken, the labor movement. But the structures also have long term consequences which have received very little attention in the current policy debate. The lower wages attract a type of worker which is very different from those which the industry has become accustomed to employ. Because the new wages make it difficult to support a settled family life style, new workers tend to be lured instead by the opportunities for travel and the glamour and excitement of the nomadic lifestyle which travel affords. As these people get older and settle down, they will either have to leave the industry or eliminate the wage differential. In the meantime, one wonders what the effect of workers attracted to such a lifestyle will be upon an industry with the exacting standards upon which safety in airlines seems to depend and what the effects of deteriorating safety are likely to be upon the argument for deregulation upon which the rationale for the two-tier wage structure hinged in the first place. Historically, moreover, two tier wage structures have served as often to enhance union militancy as to weaken the organization and that effect too will probably eventually come into play. In the meantime, the old wage setting rule in the form of the top wage tier paid the old employees remains as a visible wage setting standard. In this sense, we have an exact parallel to the automobile industry: an old wage setting principle suspended but not abandoned under managerial pressure in a loose labor market but with a strong intellectual justification. As in autombiles, the old rule in airlines remains as standard as the justification for its suspension becomes increasingly less plausible and the balance of power begins to spring back toward labor.

The basic lesson is that the discipline of the market is no substitute for a policy which seeks to think through and lay out the standards for an alternative institutional structure, and in abdicating this responsibility, the Reagan administration has sown the seeds for a renewal of inflationary wage pressures in the future.

The same problem reemerges in examining the productive efficiency of American industry. Here it is potentially more serious for it effects not simply our perception of economic well-being but the underlying capacity of the economic structure to maintain and expand our standard of living. But an examination of the issue of productive efficiency also suggests what alternative institutional arrangements might look like.

Productive Efficiency

The American economy is undergoing a fundamental transformation in its buiness structures and managerial practices. Both the issue of productive efficiency and that of institutional structures must, I believe, be understood in terms of this transformation and the forces which are bringing it about. The transformation is a response to what is perceived to be a permanent, long term shift in the business environment. The business environment earlier in the postwar period was conducive to relatively stable, predictable mass markets: the basic production strategy of American industry was one of long runs of standardized products; the basic marketing strategy was to create and maintain a market for output of this kind. In a sense, Keynesian economic policy could be interpreted as the macroeconomic counterpart of the strategy which businesses were pursuing in their own markets: it essentially validated firms' efforts by maintaining the necessary levels of aggregate demand. In the last decade, however, we seem to have entered a world which is considerably more unstable and uncertain both in individual markets and at the level of national economic activity, and in response business has evolved an alternative strategy, one which seeks out small, specialized niches in demand and seeks to fill those niches through flexible production techniques. The economic policies of the Reagan administration have contributed significantly to the business environment to which this new strategy is a response, but if the principal economic actors actually believed the new environment were basically a product of policy rather than of deeper and more fundamental forces, they would not, I think, have embarked on the long term adjustments which they have undertaken. Indeed, administration policy has won widespread acceptance, largely because people believe it is a necessary accomodation to underlying economic changes. In any case, it is widely -- and I think correctly -- perceived that the ability of the American economy to prosper and compete effectively in the international environment will depend on the success of the institutional transformation now in progress.

I have spent much of the last six months interviewing managers and engineers in large American corporations, where the institutional transformation is clearly apparent. Most of the companies which I have been looking at were historically organized in terms of a tightly integrated, rigidly hierarchical structure. They are attempting to transform themselves into souple, flexible institutions, capable of responding quickly to a shifting, unpredictable market place by generating a continual stream of product innovations. The reforms which they are introducing in order to do this range widely. They include the elimination of in-process inventories; the development of design teams which replace the traditional engineering hierarchy of product, process, and industrial engineering department; new design procedures replacing sequential engineering which moves down the old engineering hierarchy with parallel engineering; systems of matrix management in which individual managers report to more than one boss in such a way that forces lateral communication among lower levels of the corporation as managers attempt to forestall conflicts among their several supervisors by anticipating problems and working out solutions in advance; and a whole series of new and/or restructured relationships with outside enterprises which range from venture capital divisions which foster entrepreneurial relationships (and which parallel the development internally which the business press has lableled "intrepreneurship") to new cooperative relationships with parts producers in which the number of suppliers is reduced and a more permanent, long term and intimate relationship is fostered with those who remain.

These firms are also introducing reforms in labor practices ranging from quality circles to profit sharing. These reforms, taken in isolation, can be seen as part of precisely that effort to obtain greater flexibility and managerial control over the work process which Reagan's policy has sought to encourage. Certainly managers have taken advantage of their newly acquired power in the industrial relations sphere to press labor to accept the concessions in traditional collective bargaining relationships which the reforms require or to establish "union free" operations where they are not already committed to a union contract. But the view that the basic problem of American management lies in the labor practices which are being changed -- a view which was widespread in the late 70s -- is now considered to be naive. The labor reforms are part and parcel of a whole package of changes in managerial practice: they parallel reforms being introduced in the structure and practice of management itself, in the work organization of nonunion professionals such as engineers about whom management has never had either the fears of union organization nor the complaints about work attitudes and practices which pervade discussions of blue collar labor, and in relations with subcontractors and other outside organizations. Moreover, these other reforms now seem to loom much larger in the thinking of corporate strategists than those in work organization and practice, so much so that one can spend hours talking to corporate leaders in organizations where intensive labor reforms have been introduced without the latter ever being mentioned. Placed in the context of the environment in which they are being introduced, the changes in labor practice thus emerge as one piece, possibly one of the less important pieces, of a new pattern of business practice.

I am particulary conscious of these changes in large corporate organization because they have been the focus of my research in the last six months. But it is apparent in reading the business, and even the popular, press that equally dramatic changes are taking place in other economic institutions. Small and medium size businesses are developing new relationships among themselves and with large organizations which facilitate new product development, cooperative research and development, common projects for education and training, marketing, etc. State and local governments are extending their economic role into venture capital, incubators for new firms and entrepreneurs, industrial research and development, export promotion abroad, and the like. Even trade unions are developing new industrial activities which parallel changes within large corporations, and within associations of small firms, including participation in research and development for their industries and expanded roles in training and in industrial strategy.

The various different reforms are sufficiently widespread and have in many places been carried to a point where one can now begin to discern an institutional model of the new economic order and to compare it to the economic philosophy which the President has articulated. The reforms bear out one of the President's major themes: the importance of entrepreneurship and of individual initiative and creativity. This appears to be the basic explanation for the renaissance of small business. And a major theme in the reforms in large organizations is the attempt to free the individual from the restraints of bureaucratic regulation and engage him or her actively in the operation of the enterprise. This is obvious in the case of profit sharing and quality circles. But even such apparently remote changes as the elimination of in-process inventories are viewed as ways of increasing individual responsibility and calling forth personal initiatives. In a certain sense, the whole trust of corporate reform is to make the large organization behave as if it consisted of a series of small businesses. But it would be a mistake to take the competitive market place as the alternative model of the world which is being sought, at least if one means by the competitive market place the arms length, hostile, dog-eat-dog relationship which firms are supposed to have with each other in the conventional, competitive model which economists have used to derive their policy prescriptions for deregulation. The President's vision, and those of economic scholars as well, leave out a second component of these reforms which is cooperative or, I daresay, social. The individualism which the reforms are seeking to introduce is one tempered by a need for collaboration with other members of the organization and many aspects of the reforms can only be understood in terms of cooperation and the social structures which are required to insure that the cooperation will take place. Quality circles and profit sharing are both reforms designed to encourage the individual to make his or her contribution through the social group. The corporations with whom I have been talking are not seeking to increase competition among parts producers: they are seeking to reduce competition in order to draw the producers into a more participative relationship. They want more flexibility of internal work assignments for their blue collar employees but they are willing to provide employment security in return. They see profit sharing not as a means to enhance wage flexibility but rather as an expression of the relationship of participation which they would like to establish with their employees. Similarly the new relationships among small firms that are being established through trade associations, state and municipal government or in cooperation with trade unions all have the effect of strengthening the social structure in which small businesses are embedded and the cooperative relations which temper competition among them.

The reason for these cooperative arrangements is not abstract or humanitarian. Nor is it the natural tendency of businessmen to seek to forestall competitive pressure in order to win monopoly profits against which economists since Adam Smith have warned. The reason is that the kind of dynamic flexiblity required to launch and maintain a constantly shifting menu of innovative products in a variable and uncertain market place requires an intimate collaboration among the various people involved in production and marketing. The institutional reforms are designed either to enhance that cooperation or to create mechanisms for pooling risks which would otherwise operate to poison the atmosphere in which that cooperation takes place. Many managers now have an articulated understanding of what kinds of collaboration are necessary and as a result the transformation of existing institutions and business practices is increasingly pointed and deliberate. There is also a growing confidence in the ability of the changes to revitalize the organizations in which they are being introduced. But these developments do not alone constitute grounds for optimism about the position of the American economy as a whole. One cannot be optimistic in part because the very strategy of "nicheism" with which the developments are associated is one in which individual firms, or groups of firms, can prosper by picking off small pieces of an international market irrespective of the prosperity of the larger national economy in which they are located. The success in creating a local community within the corporate organization or within an industrial region frees them from dependency upon the larger national community. In the new world, to put it bluntly, even the success of General Motors will not be the success of the American economy. And much the same can be said about the success of Route 128 and Silicon Valley or the much heralded Sunrise Services.

But the other reason why the tranformations already in process are not alone grounds for optimism is that they are not the only avenue of adjustment available to American business. An alternative strategy which holds out equal promise of renewed profitability in the short run is simple cost cutting. Firms can maintain their own organizational structures and mnay of their traditional managerial practices in tact and compete by reducing labor costs through wage cuts. And if flexibility in some organizations means the reform package which I just described for others it means precisely the intensified competition among workers for jobs, suppliers for contracts, and entrepreneurs for innovative opportunities which the President's rhetoric seems to exort and which his policies encourage. In between the organizations undergoing fundamental transformation on the one hand and those involved in draconian cost cutting on the other, are a variety of firms in which the two alternatives are a matter of continual internal debate. It is, I suppose, presumptuous of me as an outsider to prejudge these issues when the professional managerial community is itself divided. Nonetheless, I do think it is clear that simple cost cutting is only a short run strategy which, however appropriate it may be for a particular company at a moment of time, will never serve the interests of a national economic system. It is no accident that our most intense competition in world markets comes from countries that have a strong cooperative tradition: Japan in large scale production and high tech, and in traditional industries like machine tools, shoes and textiles, from central Italy. When one sees how organizations in these countries function, one not only has a much clearer idea how the combination of cooperation and competition which the corporate reformers are seeking might work. One also sees a kind of dynamism in both the process and the product that leads one to believe that simple cost cutting adjustments will only keep firms in business in the long run by new wage cuts each year until the U.S. reaches the levels prevailing in the underdeveloped world. Long before we reach this level, of course, we will face the kind of spontaneous worker revolt which we saw in the 1930's. And the ultimate critique of the Administration is that instead of creating an environment which encourages the search for an alternative set of economic institutions and encouraging their development now while we still have the freedom to choose, it is pursuing an economic policy which both in its substance and its rhetoric is encouraging crude "sweating". In itself, this cannot not solve our economic problems and is rapidly creating a social climate which may well foreclose those alternatives which would lead us back to a stable long term prosperity. This policy is especially dangerous because, while American firms no longer share a single national market, they do operate together in one social structure, and the social policy which emerges in reaction to the draconian cost cutting of the least dynamic of American business is likely to constrain the policies of the most dynamic firms as well, perhaps in ways that will permanently cripple the economy as a whole.

Ms. Povich. Thank you very much.

I'd like to remind our audience that we are taking questions. So if you have any questions for the panelists, please raise your hand and a member of the staff will come by and give you a card to write the question on which will then be brought up here and I will ask the panelists. I would also like to ask the people who are asking questions to please print legibly. I'm having a little trouble reading some of the cards that are coming up here. Thank you.

Our next panelist is Audrey Freedman, who is Executive Director for Human Resource Programs at the Conference Board.

PRESENTATION OF AUDREY FREEDMAN

Ms. Freedman. I have two points, one having to do with wage flexibility, but the more important first point is to call attention to some of the other sides of the employment and unemployment problem on which we've been focusing.

Yes, current unemployment is about 8 million; and yes, there seems to be a rising level of unemployment at each business cycle peak; and yes, the current pattern of single individuals supporting themselves is probably going to continue and families however transitory are being supported by two earners. That's probably an over-emphasized negative.

I don't think we are looking at the positive side very well or very accurately. Right now in this economy we have the highest proportion of the adult population working that we have ever had. Not only did we absorb the baby boom into the labor force, but we have absorbed the increased participation of women which has been moving steadily for many decades and we have also absorbed the increased participation of teenagers.

In the current recovery we have created about 10 million jobs. This economy's job growth is the envy of Europe where double-digit unemployment is still present in most of the countries, especially in the economies that do the most to prevent job flexibility, countries such as France.

Why are we describing current employment growth so negatively under the circumstances? Why are we only seeing the negative side?

Much heavy manufacturing job loss has not been restored. We are focusing on manufacturing jobs. We are looking at the metal and the metal-working and the metal-using industries and we are fretting especially about those. And the job loss has been union jobs and these have not been restored in this recovery. They have also been the high-wage jobs and we focus on that.

Something else occurs to me as I watch the concern about unemployment prevailing over the comfort in the job creation that we have generated. That is that we are denigrating many of the jobs and the occupations and the industries that have produced employment growth. We look upon them as parasitical, not important, much less important than the jobs that have been lost. There are jobs in services. There are jobs in retail, yes, in fast food. There are jobs in medical services. There are jobs in business services and we think of them as second rate. There are jobs in small businesses. There are jobs that are part-time, yes, and free-lance and temporary jobs and sometimes they are lower wage jobs and yet sometimes they are much higher wage jobs. They are often nonunion jobs and I think that might be the source of a great deal of distress.

Most important, a large number of the employees in these new jobs are women and, to my mind, that's one of the reasons why we think of them as not so important and why we only look at the negative side of the current employment picture.

One of the reasons why there has not been more job loss in old-line, high-wage, unionized industries is the power in collective bargaining to be flexible. We have flexible collective bargaining system, unlike some other countries, and we have been using it. When the competitive heat began to get intense in our economy in the late 1970's and the early 1980's, collective bargaining showed that it has a good deal of adaptability. It permitted necessary change to occur. It did permit wage freezes. It did permit the creation of tiers to bring some wages down to a market level. It did certainly permit the relaxation of work rules. And it permitted other adjustments to meet the competition.

We even developed in collective bargaining some performance-based wage systems, something that is much easier to do, as you know, without a union. But the union group has accepted this flexibility as well.

Companies in bargaining with their unions began to stop their follow-the-leader bargaining, the pattern bargaining, and they began to look to their own survival as employers.

We, at the Conference Board, have been studying the criteria that companies use in setting wages and in the 1970's we found that the criteria was external. Everybody looked at everybody else. Wage imitation was endemic. What does everybody else do? What is the industry pattern? We will follow it.

Now in the 1980's those criteria have changed drastically. Companies are looking at their own labor costs because of competition.

They want to survive. They are looking at their own labor costs and that's the primary element in setting wages.

Secondarily, they are looking at their own company and product line profitability. They are looking internally instead of externally.

We, at the Conference Board, have concluded that there is a great deal less wage imitation in the economy. There is a great deal less wage leadership and less wage rigidity.

Now at first blush that looks like a very conservative, hardheaded conclusion. You know, tough, and probusiness. But look at what it implies! It implies that the shape of the Phillips Curve has changed somewhat. It implies that as a policy to avert inflation we do not need to administer a dose of unemployment as we were told in the 1970's; that even if we focus on cutting unemployment as we should be doing, we have much less wage inflation pressure to worry about; that in the days of the 1970's and the 1960's we may have had a tradeoff which was a severe one—but the tradeoff terms have changed because of the decline in wage rigidity in our economy.

The exact tradeoff between inflation and unemployment should be much less of a deterrent, in the 1980's, to policies designed to promote fuller employment of our human resources. We have a much more flexible and fluid employment market and wage-setting practices than we thought.

Ms. Povich. Thank you very much.

Our final panelist is Bernard Anderson, who is a visiting fellow in public and international affairs at the Woodrow Wilson School at Princeton University.

PRESENTATION OF BERNARD E. ANDERSON

Mr. Anderson. Thank you very much.

I am pleased to have this opportunity to participate in the symposium to commemorate the 40th anniversary of the Employment Act of 1946. The laudible and ambitious goals of that policy statement, in my judgment, are as compelling today as they were when the act was passed, but the difficulties in achieving such goals continue to challenge policy makers in both the legislative and executive branches of our Government.

In my remarks I want to comment on one aspect of that challenge; namely, the achievement of equity in the distribution of economic opportunity in an environment of growth.

I want to make three points. First, economic growth is a sine qua non for achieving economic equality. Second, economic growth alone is insufficient for producing an economy in which all persons willing and able to work are employed. Third, selective labor market policy, including public job creation, is a necessary complement to economic growth in generating equality of economic opportunity.

The American economy has been highly successful in creating new jobs during the last two decades, but because the labor force grew more rapidly than employment, both the number of the unemployed and the number of persons not in the labor force have increased since 1965. The unemployment rate was less than 5 percent in the mid-1960's but was greater than 7 percent throughout 1985.

The pattern of job growth has been uneven, as pointed out by several speakers on the various panels. For some time the bulk of new jobs has been in the services sector, reflecting a long-term trend in the American economy. Employment in goods-producing rose by only 5.6 percent while service sector jobs grew by 46 percent since 1970.

The imbalance in job growth has been associated with other economic trends, including a tendency for the erosion of the wage level among many previously high wage-earners, a point that Ben Harrison and others have made. Other effects of that are the development of pockets of unemployment in some geographic locations, the increase in preemployment hiring standards in many occupations.

But an especially troublesome aspect of the current economic expansion is the unequal labor market experience of different population groups. Minority group workers have not enjoyed economic gains comparable to those experienced by other groups.

Between November 1982 when the recovery began and December 1985, the black unemployment rate fell from 20.2 percent to 14.9 percent, a decline of about one-fourth. In contrast, the nonminority unemployment rate dropped from 9.6 percent to 5.9 percent, nearly two-fifths.

This means the gap between the unemployment rates of minority and other workers has, in fact, widened despite the strong expansion since 1982. Unemployment among black youth remains above 40 percent, and the proportion of such youth with jobs is at an all-time low.

Many of those concerned about inequality in American life look at the income and employment experiences of minorities during economic growth as a barometer of progress toward greater equal opportunity. During the past two decades the record in this area has been mixed, but I think it's important to recognize that a comparison of the trend in youth unemployment rates over the course of the last five business cycles shows that economic expansion has become less vigorous as a device for reducing the youth unemployment rates in recent years.

Between 1965 and 1980 the median income of black families increased four-fold from $3,800 to $12,600, but the ratio of black family income to that among white families increased from only 56 to 58 percent over the 15-year period. Similarly, black employment rose from 14.5 million to 17.8 million between 1970 and 1980, but as a result of the job losses sustained during the past two recessions, black workers held only 10.7 million jobs in late 1985.

Numerous studies of change in the economic status of minorities attempt to explain the rate and determinants of progress achieved during the past 2 decades. Although there are still debates among economists on these matters—and of course economists rarely agree no matter how conclusive the evidence—the consensus is that much of the improvement in black family income was generated by the long uninterrupted period of economic growth between 1965 and 1969 and much of the occupational advancement was influenced by greater protection against employment discrimination.

It is not possible or necessary to assign precise values to the relative importance of economic growth and labor market policies as determinants of change in the economic status of minorities during the past two decades. It is sufficient to recognize that both factors played an important role in generating wider opportunities to participate in American economic life.

During the past few years many of those concerns about the nature of economic progress have focused increasingly on a group whose social and economic status has been unresponsive to the wider opportunities generated by economic growth. This group is often called the under class, a term I prefer not to use because it suggests that those within the group are there because of perverse values and antisocial behavior. I do not think the conditions faced by the social and economically disadvantaged are attributable to values and behavior, but rather to widespread institutional barriers to their full participation in our society. When viewed in this way, the problems of the group seem more amenable to public policy interventions.

The labor market evidence of the past few years suggests to me that structural unemployment is still a serious problem in the American labor market and will require continued attention if the benefits of economic growth are to be distributed equitably throughout the population. There are several definitions of structural unemployment but what it really means is that there are jobs available but the unemployed cannot fill them.

What is clear is that structural unemployment reflects a variety of labor market problems that are unlikely to respond effectively to fiscal and monetary policies. Special targeted labor market measures are required to get at the root cause of joblessness and to deal with the social and psychological factors as well as the economic causes for unemployment.

It is fashionable today to say that social policies designed to deal with structural unemployment and other problems of economic inequality don't work and only represent wasteful public spending. This argument is not new but it has taken on new life and is shared more widely now that ever before. Many of those who make the argument that Government has no useful role to play in promoting greater economic equality through intervention into the labor market often call upon the private sector to replace social policy.

Now it's interesting that every 20 years we seem to rediscover structural unemployment. Every 15 years we rediscover the under class and every 10 years we rediscover the private sector. In keeping with the periodicity of such concerns, some now suggest that we tackle structural unemployment in order to arrest the growth of the under class and that we call upon the private sector to play the major role.

There is no question that the private sector must be involved in any effort to improve the distribution of economic opportunity, but there continues to be a major and often initiating role for public policy.

Let me hasten ahead—I see the red light on here—to say that in my judgment there are two key policy options for addressing the problems I have mentioned earlier.

One is a policy to expand income transfers to raise the minimum acceptable income for families. The other is a set of policies designed to enhance human resource.

As between those two, I think it is both more feasible and politically acceptable today to support policies designed to develop human resources than to increase income transfers. And as I describe in the paper, I think it is pretentious academic hogwash to suggest that all jobs programs developed during the past 20 years to assist the economically disadvantaged have not worked.

The National Academy of Sciences recently reported on the Youth Employment Demonstration Project Act. The NAS study, in my judgment, is a snare and a delusion. It is based upon a completely erroneous view of those programs and suggests that nothing worked. I am here to tell you that many of those programs did work, that when you look at the work of the Manpower Demonstration Research Corp. in New York that has evaluated a number of these problems, we can conclude that targeted, well-managed, well-designed jobs programs have been effective in improving the economic status of many disadvantaged workers.

And I suggest to you that as we look toward the future in trying to improve productivity, trying to control inflation, and trying to achieve greater competitiveness in international markets, we should remember that the Nation, in my judgment, has a commitment to full participation of all segments of our population in our economy and that in order to fulfill that commitment it will be necessary to support labor market policies aimed at structural unemployment. We cannot assume that the market alone will solve the problem of structural unemployment. It never has and it never will.

[The complete presentation of Mr. Anderson follows:]

Statement of

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for the
Symposium on the Fortieth Anniversary
of the Joint Economic Committee
February 17, 1986

"Creating Jobs and Raising Incomes"

Mr. Chairman and Members of the Committee

I am pleased to have the opportunity to participate in this symposium organized to commemorate the 40th anniversary of the Employment Act of 1946. The laudable and ambitious goals of that policy statement are as compelling today as they were when the Act was passed, but the difficulties in achieving such goals continue to challenge policymakers in both the legislative and executive branches of our government. In my remarks this morning, I want to comment on one aspect of that challenge, namely, the achievement of equity in the distribution of economic opportunity in an environment of growth.

U.S. Performance in Job Creation

The American economy has been highly successful in creating new jobs during the last two decades. Between 1965 and late 1985, employment grew by 37 million, or about 50 percent. During the same time, the U.S. labor force surged from 76.4 million to 116 million, an increase of slightly more than 50 percent. But, because the labor force grew more rapidly than employment, both the number of unemployed, and the number of persons not in the labor force have increased since 1965. The unemployment rate was less than 5 percent in the mid-1960s, but was greater than 7 percent throughout 1985.

The vigorous job creation economy has been amply demonstrated during the recovery from the 1981-82 recession. During the past three years, more than 7 million people have found work. The percentage of the working-age population in the labor market grew from 57.2 percent in 1982 to 64.9 percent in 1985, and the number of unemployed dropped from 10.7 million to 8.0 million.

Uneven Growth

The pattern of job growth, however, has been uneven. For some time, the bulk of new jobs have been in the services sector, reflecting a long term trend in the economy. Employment in the goods producing sector rose by only 5.6 percent, while service sector jobs grew by 46.4 percent since 1970.

The imbalance in job growth has been associated with other economic trends including a tendency toward the erosion of the wage level among many previously high-wage earners, the development of pockets of unemployment in some geographic locations, and the increase in pre-employment hiring standards in many occupations.

An especially troublesome aspect of the current economic expansion is the unequal labor market experience of different population groups. Minority-group workers have not enjoyed economic gains comparable to those experienced by other groups. Between November 1982, when the recovery began, and December 1985, the black unemployment rate fell from 20.2 percent to 14.9 percent, a decline of about one-fourth. In contrast, the nonminority unemployment rate dropped from 9.6 percent to 5.9 percent, nearly two-fifths. This means the gap between the unemployment rates of minority and other workers has, in fact, widened despite the strong expansion since 1982. Unemployment among black youth remains above 40 percent, and the proportion of such youth with jobs is at an all time low.

Equal Opportunity and the Underclass

Many of those concerned about inequality in American life often look at the income and employment experience of minorities during economic growth as a barometer of progress toward greater equal opportunity. During the past two decades, the record in this area has been mixed.

Between 1965 and 1980, the median income of black families increased fourfold, from $3800 to $12, 600, but the ratio of black family income to that among white families increased from only .56 to .58 percent over the 15 year period.

Similarity, black employment rose from 14.5 million to 17.8 million between 1970 and 1980, but as a result of the job losses sustained during the past two recessions, black workers held only 10.7 million jobs in late 1985. Black workers showed occupational advancement during the years since 1965, but by the early 1980s, half were still concentrated heavily in the low and semiskilled blue collar and service jobs.

Numerous studies of change in the economic status of black Americans attempt to explain the rate and determinants of progress achieved during the past two decades. Although there are still debates among economists on these matters (economists rarely agree, no matter how conclusive the evidence) the consensus is that much of the improvement in black family income was generated by the long, uninterrupted period of economic growth between 1965 and 1969, and much of the occupational advancement was influenced by greater protection against employment discrimination. It is not possible (or necessary) to assign precise values to the relative importance of economic growth and anti-discrimination efforts as determinants of change in the economic status of black Americans during the past two decades. It is sufficient to recognize that both factors played an important role in generating wider opportunities to participate in American economic life.

The Underclass

During the past few years, many of those concerned about continuing progress in civil rights have focused increasingly on a segment of the black community whose social and economic status has been unresponsive to the wider opportunities generated by economic growth and the protection of basic rights. This group is often called "the underclass," a term I prefer not to use because it suggests that those within the group are there because of perverse values and anti-social behavior. I do not think the conditions faced by the social and economically disadvantaged within the black community are attributable to values and behavior, but rather to widespread institutional barriers to their full participation in our society. When viewed in this way, the problems of the group seem more amenable to public policy intervention.

Nature of Structural Unemployent

The evidence suggests to me that structural unemployment is still a serious problem in the American labor market, and will require continued attention if the benefits of economic growth are to be distributed equitably throughout the population. There are several definitions of structural unemployment, but what it really means is that there are job vacancies, but the unemployed cannot fill them. This may be due to the unemployed being in the wrong place, demanding wages that are too high, having inadequate education and training, or being victims of discrimination.

There are many determinants of structural unemployment, including the loss of jobs due to competition from foreign imports, shifts in labor requirements due to technological change, and the terms of eligibility for income transfers to low income families in relation to wage earning opportunities in the job market. What is clear is that structural unemployment reflects a variety of labor market problems that are unlikely to respond effectively to fiscal and monetary policies. Special targeted labor market measures are required to get at the root cause of joblessness, and to deal with the social and psychological factors, as well as the economic causes for unemployment.

It is fashionable today to say that social policies designed to deal with structural unemployment and other problems of economic inequality don't work and only represent wasteful public spending. This argument is not new, but it has taken on new life and is shared more widely now than ever before. Many of those who make the argument that government has no useful role to play in promoting greater economic equality through intervention into the labor market often call upon the private sector to replace social policy in this field.

Indeed, every 20 years, we seem to rediscover structural unemployment; every 15 years we rediscover the underclass; and every 10 years, we rediscover the private sector. In keeping with the periodicity of such concerns, some now suggest that we tackle structural unemployment in order to arrest the growth of the underclass, and that we call upon the private sector to play the major role. There is no question that the private sector must be involved in any effort to improve the distribution of economic opportunity, but there continues to be a major, and often initiating role, for public policy.

Policy Choices for Reducing Economic Inequality

There are two key policy options for addressing the problems of income inequality among those who do not share fully in economic growth: income transfers and human resource development. Under the first type of policy, the goal is to provide an income sufficient to allow families to maintain a minimum acceptable standard of living. Under the second, the goal is to raise the individual's productivity in order to improve employment and earning prospects in the labor market.

Of the two policies, I believe the most advisable, and politically feasible approach at this time, is the human resource development strategy. To be sure, if our national goal is simply to reduce poverty, and to equalize reduce poverty, and to equalize income, one might argue that human resource development policies are likely to be less effective than income transfer programs. Indeed, according to a study by Peter Gottschalk and Sheldon Danziger at the University of Wisconsin[1], the dramatic reduction in poverty during the 1960s and early 1970s resulted from a combination of rapid economic growth and increased transfer payments. Although such benefits contributed most to the reduction of poverty among the elderly, the relative income of other age groups also showed improvement as a result of income transfers.

But despite the fact that the reason people are poor is that they don't have money, there is no public sentiment for large and continued transfer of unearned income. Even more, there is a deeper reason to question a policy emphasizing larger transfer payments: labor is not only a factor of production; work is an essential human value. The best long-term solution to the problem of inadequate family income is policies designed to expand opportunties for low income workers and the unemployed to participate more fully in the labor market.

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[1] Peter Gottschalk and Sheldon Danziger, "Macroeconomic Conditions, Income Transfers, and the Trend in Poverty," in Lee Baldwin (ed.), An Assessment of Reagan" Social Welfare Policy. (Washington: Urban Institute, 1984.

Employment and Training Policy:-the-Record

Much has been written about the failures of job training programs to improve employment and earnings among disadvantaged populations. Unquestionably, many mistakes were made and many dollars were wasted in some of the employment and training programs of the past two decades. But a careful reading of the daunting problems such programs tried to address, and the importance of institutional change at the federal, state, and especially the local level in delivering education and training services to the structurally unemployed.

The failure to fully appreciate the complexity of the task is reflected in the recently completed, National Academy of Sciences study of youth employment and training programs in operation between 1977 through 1981[2]. The NAS verdict is that such programs were a failure because they did not reduce significantly the youth unemployment rate. Quite apart from the fact that the negative conclusion of the study was based on the failure of program operators to measure accurately what they were doing, a careful assessment of the YEDPA programs must recognize the difficulties policy administrators faced in launching a mult-million dollar program, in a short period of time, when the delivery system was changing rapidly to absorb new funds.

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[2] Natural Research Council,
Youth Employment and Training Programs: The YEDPA Years (Washington: NAS, 1985.

Still, the record of success of youth employment programs is greater than the NAS study implies. For example, the favorable record of the Youth Incentive Entitlement Pilot Projects was revealed in a study by the Manpower Demonstration Research Corporation, a New York-based research and evaluation firm. The Entitlement Programs was authorized by Congress in 1977 to test the link between schooling and employment for disadvantaged youth. The program was targeted to low income teenagers in 17 communities. A guaranteed job at the federal minimum wage was provided so long as the youth remained in (or returned to) school, and achieved satisfactory performance in both school and work.

During the two and one half years the program was in operation, 76,000 youths worked in program jobs. Most were young minority group members enrolled in school and members of welfare dependent families. Few had ever held an unsubsidized job, and most had never participated in other federally assisted jobs programs. There were major gains for program participants: more than half of the eligible youths in each area participated in the program, and the communities showed they could deliver on a job guarantee. Most important, school year employment more than doubled for black youths, reversing the 25 year gap between black and white employment rates. The study showed major weekly earnings gains for participants, especially during the school year.

Other labor market programs also have shown promising results. Among such programs are the work/welfare initiatives authorized by Congress as part of the Budget Reconciliation Act of 1981. Under this policy, several states have launched pilot projects designed to encourage welfare recipients to enter the job market. Various measures are being tested, including the diversion of the cash grant to wages for public-service work, the provision of job search assistance, and in some cases, occupational training.

MDRC studies of projects in California, Viriginia, West Virginia, Maryland, Illinois, Arkansas, New Jersey and Maine show modest, but perceptible reductions in welfare dependency among program participants. The combination of job search assistance, work experience, and other services helps many welfare recipients get into the job market, even in areas where unemployment is higher than the national average.

Similar results are shown in work/welfare projects in Massachusetts and New York. Although those projects have not been evaluated to compare program participants with similar welfare recipients who did not participate, the job placement rates, 35 percent in Massachusetts, is very favorable. Undoubtedly, a strong labor market helps explain the favorable results, but it is unlikely that the welfare dependent population would benefit as much from rapid job growth in the absence of state-assisted jobs programs.

Another successful example of a youth employment program is Jobs for America's Graduates. After more than a decade of experimentation with school-to-work transition programs, a pilot project was designed and tested in Delaware. Organized with the initiative of Gov. Pierre DuPont, the project brought representatives of the school system together with business, labor, and community leaders. Under the project, high school seniors, mainly enrolled in general education and without clear career goals, were selected for a series of counselling, job-preparation, and job-placement sessions during the regular school day. The tutoring sessions were led by specially recruited job counsellors who were assigned to the high schools. The job counsellors, most of whom had private sector rather than professional education experience, taught students the rudiments of job search, and also beat the bushes among local employers to identify jobs for high school graduates. As an added incentive to spur staff productivity, each job counsellor's salary increase (and employment retention) was tied to success in placing youth in jobs and keeping them there for a reasonable time after placement. The Delaware project was remarkably successful in its first year, and showed an 80 percent placement rate for high school graduates within three months. Based on this success, the program was expanded to more than 100 high schools in eight states; more than 25,000 students have participated during the past five years.

Overall, JAG shows a 70 percent placement rate for participants within three months of high school graduation. The benefits from program participation seem greatest for minority youths, especially those with prior marginal academic records. Again, this evidence suggests the important linkage between school performance and job prospects.

Finally, after 20 years of controversy, the Job Corps has recently received a favorable evaluation of its impact on the disadvantaged unemployed. The Job Corps serves 60,000 youths, two-thirds of them minorities, and all of the, high school dropouts. Program participants receive help in basic skills, occupational training, job finding skills, and placement assistance. Over half of those who complete the program get jobs, and their earnings increase signficiantly more than similar youth who did not participate in the program. A Princeton-based firm, Mathematica Policy Research, evaluated the impact of the Job Corps and in

1984 reported that the program pays for itself in three years, despite the relatively high cost of $6,244 per member.

Economic Growth with Equity

The jobs programs briefly noted above demonstrate the feasibility of labor market policy designed to achieve full employment with equity. Even in an environment of rapid job growth, some members of the population will be left behind. No amount of economic growth alone will help them gain a foothold in the economy. As we move forward to improve productive capacity; to achieve maximum use of resources; to keep control over inflation; and to improve our position in the world economy; it is important to remember the national commitment to full participation of all segments of the population in our economy.

To assure that commitment, it will be necessary to support labor market policies aimed at structural unemployment. We cannot assume that the market alone will solve the problem of structural unemployment; it never has, and it never will.

Ms. POVICH. Thank you very much.

I am going to turn now to questions from our audience and I wanted to point out that many of these questions are directed to an individual panelist. Some of them are directed to the panel as a whole and I will be asking various others of the panel to comment on some of the questions. If any of the members of the panel would like to jump in at any time, please just catch my eye and I will be happy to get your comment at the same time.

We have a number of questions here talking about wage disparity and one question here asks that if we could somehow identify those that are overpaid in the U.S. economy, how do we address this? The questioner would like to know about retraining or relocation. And along those same lines, one questioner says, how do you go to a steel worker in Wheeling, WV and say, "$25 an hour simply is not competitive. You either reduce your wages or you lose your job."

Could we have a comment on that first from Professor Harrison?

Mr. HARRISON. I'd better be awfully selective in the comment because that's five questions worth a 2-hour answer.

It's always taken out of context when high-wage workers' high wages are being challenged—always taken out of context.

Historically, the high wages of those workers were based upon higher than average productivity. Those high wages were earned. That objective conditions have changed—that company neglect of their property has destroyed productivity, that these is a world glut of basic steel, and so forth—obviously changes things. But don't start the assessment of the problem by characterizing people who worked their tails off as simply making too much money. It's just an unfair thing to do. A lot of the rest of the population wishes that it were being paid wages commensurate with the amount of effort they have made throughout their lives.

Second, the problem with getting wages in particular sectors more into alignment with the current competitive environment is a problem of economic development, not a problem that should be solved entirely through collective bargaining. The problem is that there aren't enough good jobs in those communities experiencing the cutbacks to reabsorb the displaced workers. That's my answer to Dr. Kosters' argument about gross versus net. The gross changes matter. The distribution story is in the gross changes. When you talk about net change you abstract from who's paying and who's benefiting, from who's suffering the pain and who's not.

The point then is that if we could fashion policies to redevelop the communities, the regions, the cities, the neighborhoods, the parts of the United States where people are suffering loss of employment or where objective competitive conditions have undermined their ability to make a living, to provide alternative work and intersectorally balanced economic growth, then in that context the adjustment of wages in particular occupations in particular industries would be a much more politically acceptable and easy thing to be able to do.

That's what we're not doing. We're trying to lay the entire stress of competitive change on the wages of individual workers, and then characterizing it as their fault because they're making too much money.

Ms. Povich. Mr. Kosters, would you like to say something in response to that?

Mr. Kosters. Well, let me comment very briefly on the case of steel workers. I think it's very difficult to say whether a person or whether an occupation is overpaid. But if you look at the case of steel workers, and to a somewhat lesser extent the case of autoworkers, and some other groups as well, you find that during the 10 years from 1973 to 1983, wages of those workers went up a great deal relative to wages of the average worker in the economy. That is, the ratio of the wages steel workers earned compared to the average worker was much higher by 1980 than it had been about 1970.

Now there could have been good reasons for that, if demand for steel was very strong, skill requirements were rising, and so on. But I think it's very difficult to point to such factors in this case.

One factor that I would point to, though, is the operation of the cost of living escalator provisions that Professor Piore mentioned earlier. This was the period of "experimental negotiating arrangements" in the steel industry where management apparently thought, by looking backward, that avoiding a strike was the main goal rather than keeping labor costs down.

So it seems to me what we have had in some of those industries is not just higher wages than average, but relative wages that rose a great deal during that inflationary period.

Now let me say a few brief words about gross versus net change. I think that gross change, being as enormous as it is, is a poor indicator of whether net new additional jobs are being created or whether real incomes are rising. Indeed, I think of it as an indication of health in the labor market to see a great deal of gross change.

I also believe that gross change has not led to inequality. I don't want to get into a shooting match over numbers. However, when I look at earnings of individuals reported in the current population survey over the last 12 years, I see a significant decline in dispersion in wages of individual workers. That is not the case for some other measures of dispersion that I know about, but it is true for earnings of individual workers.

Ms. POVICH. Thank you. Professor Piore, your comments evoked about three or four questions here all in the same lines and most of them have to do with new social structures. A number of the members of our audience would like you to describe what you mean by the institutional and social structures which must change and then elaborate on what the work world might be like if the compatibility between these structures and the economy were to occur?

Along those same lines, another questioner asked what are the features of the new social structure needed for the United States to improve its chances in the future.

Mr. PIORE. Well, it's easier to invoke the term social structure than to describe it in its full-fledged glory, but let me focus specifically on manufacturing.

I don't agree that the United States has had a labor market that one would characterize in any meaningful sense as flexible. It has had different areas of flexibility and rigidity than the European labor market has had. In particular, we have had freedom on the part of employers to lay off workers; that is, to vary the level of employment. But in return, American manufacturers, particularly in the blue collar sector, paid for that freedom by an elaborate system which we call the seniority system, although I think that that name does not really evoke all that's involved, which was a set of rules which govern both the way in which workers are laid off and recalled and the way in which their wages are set and paid.

In order for those rules to work, we have had a series of very strict job definitions. One of the big differences between Europe and the United States is that in Europe an employer can tell virtually any worker in the shop in most countries what they want them to do, whereas in the United States that freedom has in the past been highly restricted by various kinds of rules governing work assignments and those rules are critical to the way in which we allocate jobs and pay wages.

Now I would say that, if you were going to focus on the labor market as a source of problems, it is those rules that have been the biggest source of problems for American manufacturing. The tenor of those rules has extended to all sorts of other aspects of the way in which we have done business historically in manufacturing in the United States.

Just to give you another example, we use enormous in-process inventories. The reason why we use those in-process inventories is because we treat each work station as an isolated work station and a lot of our productivity has come out of looking at these work stations individually. However, since they are each operating individually according to their own logic, you want to have parts between them so they don't infect each other if they happen to go down. In other areas, the way our engineering is operated has been very hierarchical. You design the product and then pass it to the manufacturing engineer who designs the process and then to the industrial engineer who designs the job and so on until you have a whole series of structures which go from labor relations on the one hand to the basic tools of management on the other.

I think if you talk to manufacturing managers, as I've been doing in the last 6 months, what you see is that all of those structures are changing together. Indeed, if you talk to managers you never hear them talk about industrial relations and labor changes even in the companies that are most advanced in those kinds of changes, but there are parallels between the changes which are taking place in engineering and eliminating in-process inventories and so on, and the changes that are taking place in industrial relations. The major change in industrial relations is that we are eliminating new job assignments and going to much broader job assignments and much broader training.

Now the question is what kind of overall system is that particular change compatible with? As I look around the world at other countries, in particular Japan which is serving as a model for a lot of these changes but also I think in the European countries, the kinds of changes which American manufacturers are pushing toward in other countries inevitably involve exactly the employment guarantees that Professor Kosters thinks are responsible for a low rate of employment growth abroad. It involves employment guarantees because if you guarantee employment you don't need the kind of seniority system that allocates the jobs fairly that are left behind, and it involves very different wage-setting systems: wage-setting systems that are in part profit sharing systems but that are also in part payment linked to knowledge rather than jobs, payments linked to individuals. I want to point out to you that a lot of our wage flexibility in the United States comes from the fact that we link our wages to jobs, so when somebody gets demoted in a seniority system their wages fall.

Now in Europe and in Japan wages tend to be linked to the individual characteristics and that gives you much more flexibility in the allocation of labor internally but it does not give you the kind of wage flexibility which is so much admired in the United States in terms of macro-adjustment.

Now I think those things go together, these various characteristics. In the short run you might get everything that you consider desirable from the point of view of making the macroeconomy work effectively because what we've particularly done in the short run in the United States is that we have sort of suspended any social system at all. Unions are very confused—that is, they talk a good game in public, but they're really very confused as to what they can legitimately ask for, what is consistent with the preservation of jobs in their industry. But that confusion is not going to last forever.

The last time we had anything like this confusion in the U.S. labor market was from 1931 through 1933 and it produced the industrial union movement. In the end, we got a new social system. American management is gradually moving toward kind of a perception of what that new social system is going to look like. It's focusing on those changes, figuring out how they fit together into a system and what the place is for institutions like trade unions and worker representation in that new system that I think is going to make the U.S. economy be efficient. It's difficult, particularly in a short space of time, to say what that new system is going to look like, but I think it's going to be employment guarantees; I think it's going to be partly profit sharing but I think that's been overdone. The shift is much more toward payment to individuals rather than jobs for particular kinds of qualifications and for progression. It's going to be toward much broader training within the enterprise. It is not going to be something that makes the labor market look like it was the stock market and where wages rose and fell like the price of IBM stock has in the last few weeks.

Ms. POVICH. Anybody else want to take on the social structure question or should I just leave that one be at the moment? OK.

You mentioned foreign companies just now and a question from the audience is that do any of you expect that multinational corporations will be a major factor in reducing the real wages paid to U.S. workers?

Mr. PIORE. I can tell you what American manufacturers are telling me and I'm not quite sure how that plays out in terms of overall wage levels, because it seems to me that the real question it suggests is more about qualifications and about looking for the proper term here, but what you're going to do to the unskilled end of the labor force.

American manufacturers say that the pace of automation is moving so rapidly that labor costs are going to be less and less of a factor in industrial location and, hence, in the next 10 years they expect that they will no longer—that is, at the end of a 10-year period—they will no longer be interested in using the underdeveloped or developing countries with low wages as a basic place to locate manufacturing employment. Now that is going to take a lot of the pressure off the blue collar employees particularly in order to compete on the basis of labor costs.

On the other hand, the other thing that American manufacturers are saying is that they want to locate close to the markets. They have already anticipated and discounted in a sense all the pressures for protectionism, and their feeling is that you have got to locate your manufacturing facilities in the major markets where you're going to sell. So they are no longer interested in the long run in locating in Southeast Asia, but they are talking about moving their manufacturing facilities to France, Brazil, Mexico, India, Germany and so on, major markets. And that kind of move to manufacture within the tariff barriers of these areas is, I would think, the major threat to American manufacturing or production employment in the future.

Now that these companies conceive of, which I can't quite see how it's going to work as a system, but their notion is to maintain product engineering a development in the United States and in a sense to do all that on computer-aided design facilities and then to use long-distance telephone lines in order to communicate those design facilities directly into dispersed manufacturing operations in the sources of major markets.

So if you played that scenario through, it would leave us behind with relatively little manufacturing jobs but the source of the competition of pressure would be coming from a very different source and something which I emphasize has very little to do with wages and is already happening. That is, in response to this notion of protectionist pressures, not just in the United States but in other countries, and then it would leave us—if those other countries are willing to tolerate the immense centralization of the technology in the United States that this seems to imply and the power that presumably goes with it, it would leave us with the kind of what I guess are properly counted more as service than production jobs in the United States.

But there are a series of problems in that and the biggest one, as I said, is whether the rest of the world is going to tolerate that kind of dispersion.

But the other question which it leaves very squarely on the table is the question that Professor Harrison has been pushing so hard to get on the agenda which is—well, the missing middle, but I guess we might be missing one of the ends of the distribution as well when all this is done.

Ms. POVICH. Thank you. Congressman Scheuer, do you have a question for the panel?

Representative SCHEUER. Yes; this whole problem of structural unemployment is one of the most pernicious problems in American society today. I think we can all agree on that. It's poisonous and it is creating an under class and it does have racial overtones and it's something that we've got to lick and it isn't easy. We've been working on it ever since I first came to Congress in 1964 and when I was on the Education and Labor Committee in 1965 we passed the new careers program that was aimed at structural unemployment and took people out of the ghettos and gave them on-the-job training, release time for remedial education and put them in jobs as aides in public service and it was a great program and my modesty prevents me from identifying the author of the program.

We haven't gained any ground. We've been talking about this disparity—minority unemployment has been between 2 and 2½ times white unemployment for the last 20 years as a rough rule of thumb and I don't think we've made any progress.

I think the job programs under the poverty program were great and maybe they were only 50-percent effective, maybe they were only 40-percent effective in terms of their success rate with those kids. But if you look at their constituency and if you look at the multifaceted problems that those kids brought to the programs, the fact that we were able to get 30 or 40 or 50 or 60 percent of them into the mainstream was a bloody, marvelous miracle.

But if you look at the nature of the times, whether we have a Democratic administration or a Republican administration, I don't get the feeling that large-scale public employment programs are in the cards in our immediate future. I think we have to think about other ways of approaching the problem of structural unemployment.

I'd like to hear views that any of you have. I specifically would like to hear what views you might have on how we can lick the problem of functional illiteracy, which I feel plays a major part in structural unemployment, and total illiteracy, which is a problem we have that no other advanced industrial society has. How do we lick that? And what are the other things that we can do to make real inroads in this problem of structural unemployment that has such awful, shameful implications for the quality of our life and the quality of our democracy and the quality of fairness and equality and decency in our country?

Mr. ANDERSON. Congressman, might I be the first one to take a crack at this because I have looked very carefully at the manpower programs of the 1960's and the 1970's and have written on this subject.

It seems to me that what the Congress tried to do in the 1960's through the Great Society Programs, Model Cities and a variety of other efforts was to widen opportunities for many disadvantaged people and disadvantaged communities which in the absence of the kind of Federal initiatives taken at that time simply would not happen. I am compelled to say, though, that some of what the Congress did, in my judgment, was done with the best intentions but was not carried out very well.

One example, in my opinion, was the Neighborhood Youth Corps which all too often was a snare and a delusion as it was carried out at the local level where kids were hired during the summer to scrape graffiti off the telephone poles after putting it on for 9 months of the academic year. In fact, all they accomplished was to create their own employment, you see.

The point is that it seems that there's a problem in legislating at the national level to achieve certain objectives and having those objectives in fact carried out at the local level.

So that suggests to me two things. One, the implementation of these programs should be moved closer and closer to the local level. That is, perhaps the Congress can establish a national policy objective, but then send the funds down to the State and local levels and let the design of the effort be done at that point, let it be carried out at that point, and diversify the delivery mechanisms.

For example, over the past 20 years there have emerged a number of community and neighborhood organizations, in some cases they include community development corporations. These are local, private organizations, run by people in communities, who know their areas, who are familiar with the condition of life in those communities, and with the assistance of public funding can probably do a better job than State and local governments.

One of the problems with the Public Service Employment, quite frankly, was that it often led to the employment of some people who would have been hired otherwise even in the absence of that. The point is that you can have a publicly supported jobs program that does not have to be carried out by a public agency. That's one thing that strikes me.

The other point, though, is that these efforts often are done at such haste that they almost invite failure. If you look at the

YEDPA experience, for example, in 1977, at the very same time that YEDPA was being implemented at the local level, there was also an expension of public service employment and a number of other initiatives that were undertaken by the Carter administration. the delivery system at the local level simply could not absorb all of that fast enough and before the system had shaken out we had a new administration and the whole thing was just turned overhead.

What I'm saying I guess is that, No. 1, we must recognize that those kinds of initiatives with public support continue to be absolutely essential. It is nonsense to say that the private sector alone is going to solve this problem. It isn't. The private sector and the public sector together must help solve this problem.

Second, we must target many of these funds to specific groups. We have heard, for example, that you can't do anything about the welfare program. Well, when you look at experiences—and that's the topic of a different panel today, but I hope someone on that panel will tell you of the favorable results in Massachusetts, in California, in West Virginia and many other communities under work welfare projects where a number of people on welfare now through a variety of mechanisms are gaining job skills and they are getting into the job market.

What we need to do is identify those things that work, to continue funding them, and to have the courage to stop funding those things that are demonstrably ineffective. I think that's the policy we ought to pursue.

Representative **Scheuer**. Thank you.

Ms. **Povich**. Professor Harrison, you have a comment?

Mr. **Harrison**. Yes. I wanted to address this question also, and to rather shamelessly use it as a way to bring in a disclaimer of sorts to one of the observations that Audrey Freedman made earlier.

There's a kind of a bias—I think it's an ideological bias—in political discussions about structural unemployment and the bias is that they tend to focus on the impairments, the inadequacies, the problems of the people, of the structurally unemployed. Just as the word "inequality" in politics and journalism tends to be a buzz word for black people, so I think "structurally unemployed" tends to connote people who don't have the skills and aren't literate and don't know how to count and don't show up to work on time. To some extent those things are true and one oughtn't to back away from them.

But fundamentally, an important part of the problem of structural unemployment has to do with the shape of the demand for labor; what kinds of jobs are created, what kinds of work schedules, the opportunities for on-the-job training and upward mobility. It should be pretty obvious that you can't cut paper without a scissors. Well, think of the labor market as a scissors. One blade of the scissors is the skills and capabilities and attitudes of the people in the labor market, but the other blade of the scissors has to do with the people who are running the shop, the employers, who control the demand for labor. In the 1960's and 1970's, we understood that you had to work on both sides of the labor market. That's what, for better or for worse, public employment was about, trying to work on the demand side of the scissors. We seem to have forgotten that in the 1980's.

Why, asks Audrey Freedman, are some of us so concerned about the proliferation of small business, retail and service jobs, back office, operations, row upon row upon row of word processing stations in big insurance and accounting firms and so forth? Is it even possible that we denigrate these jobs because they are so heavily female? That's a very interesting charge, Audrey. And I think I'm enough of a feminist to recognize the nature of the criticism.

But I have to suggest that I think you've got the causality backwards. I think that the powerful desire and need of women to work, together with their political powerlessness, helps to give employers an opportunity to restructure the work, set pay rates in ways that proliferate low-wage forms of work. And by the way, unlike in manufacturing low-wage jobs, low wages in nonmanufacturing almost always means low or no fringe benefits as well.

But if the relative powerlessness of women (and, for that matter, people of color) is what allows this relative disadvantage in the labor market, then the obvious solution is to empower low-wage workers. Unionization is the conventional American mechanism for empowering people who work, but I'd take any organizing method and any way that people can find that will do the job.

As it did in the 1930's, public policy needs to be refashioned to actively promote the organizing low-wage, nonmanufacturing workers to be able to reconstruct conditions in the workplace.

Representative **Scheuer**. Nobody said anything about functional illiteracy or full-blown illiteracy.

Ms. **Povich**. Mr. Kosters asked to make a comment on your overall question.

Mr. **Kosters**. I think you put your finger, Congressman Scheuer, on a very important problem and I wouldn't pretend to have the answer to it. Maybe you'll get some answers from the education panel this afternoon. I hope so. But I would make the comment in defense of low-wage jobs. Suppose there has been a proliferation of low-wage jobs. Maybe it's a good thing if we have people with relatively low earning capacities. These are people who somehow didn't succeed in school. They are people many of whom didn't succeed very well in school in acquiring literacy, so in a sense the job market is a second chance for them.

It seems to me that these circumstances may become relevant to policy at some point. We're all aware, for example, that the real level of the minimum wage has declined in recent years. One of these days we may well see proposals to increase that minimum wage.

What I would do is to urge you, when you consider proposals to increase the minimum wage, to think about what the consequences that are likely for employment opportunities for people with poor literacy, with poor earning capacity. It's not just a matter for them of sometimes having no job at all. It is also important that when you increase the minimum wage it makes it extremely difficult for the employer to hire a person, pay a very low wage, and to provide some on-the-job training in addition to permit advancement. Having a low-wage job is better than no job at all, and the training that comes with the job may be more important for the future than higher current wages.

Ms. POVICH. Thank you. I'd like to ask the panelists, with the coming budget-cutting axe of Gramm-Rudman, what are the impacts of this effort on wage disparity and, conversely, if we are able to get the deficit down to perhaps half of what it is now, $100 billion instead of $200 billion, is this going to increase or decrease the wage disparity in the country's workers at the moment?

Mr. PIORE. I guess I don't have a view on that question. I think what's left out in that is the concentration on the role of Federal Government and its withdrawal from the economy. What is left out is we've had an enormous expansion of the role of State and local government in the economy and that in terms of what the impact of the role of government on the direction of the economy is, I think you have to look at efforts of State and local governments to promote small business, to promote exports, to get involved in venture capital, and so on, in their own local areas.

I guess that I would say that it's more than Federal efforts that are likely to affect the direction both of development in this country and underlying factors generating the wage structure.

Ms. POVICH. Dr. Anderson, can you make the case for Federal jobs programs under the constraints of Gramm-Rudman?

Mr. ANDERSON. Well, it's difficult to answer that question as you put it. If you say make the case for jobs programs under Gramm-Rudman——

Ms. POVICH. Well, with the increasing pressures to compete for what little Federal money there will be can you make the argument that the Jobs Training Program will put back into the economy——

Mr. ANDERSON. Well, the only case that I would make is that cutting the heart, to the extent that Gramm-Rudman would do this and I haven't looked at the budget—I guess it came down the other day—to see how some of the jobs programs would be affected, but to the extent that the Gramm-Rudman would cut the heart out of these programs it runs completely at odds with what I think the country needs at this time to deal with the very serious problem of structural unemployment in some communities. There's no question. I have no hesitation in saying that that is not a productive public policy, that in fact, what we ought to be doing is spending more to deal with the special problems of individuals and—you see, one of the problems with this kind of discussion and I guess my perspective is a little bit different—I am familiar, enormously familiar with the work of Ben Harrison and Mike Piore and others who look in a very valuable way at the macro issues.

I guess I have looked more at local communities and have seen in many communities the real life human consequences of some of the macro issues we're talking about. I spent part of last week in Miami in Liberty City, a city that 5 years ago was burnt out because of a riot. Over the past year I have visited a number of the communities that went up in flames 20 years ago. What you find in those communities is a condition of despair that, if anything, is much worse than it was at the time those cities went up in flames.

We are celebrating this week the first public holiday of Martin Luther King and I don't want to dwell on that, but the point is,

when you look at the broad description of society that he spoke about, we're much farther away from that in many communities today than we were in 1963 when he made that brilliant speech at the Lincoln Memorial.

So I think if you really are concerned, if the Nation is really concerned with doing what is necessary to make the American creed meaningful to all groups in this country, that you simply have to recognize that there's a certain level of public—not Federal, but public responsibility that has to be carried out. These are not problems that States are going to be able to deal with on their own. These are not problems that local communities are going to be able to deal with on their own. They are certainly not problems that the private sector is going to be able to deal with on its own.

So when we pursue a budget policy that says we've got to cut this, that and the other thing in order to balance the budget, I think we do so at great disservice to the achievement of the American dream and the accomplishment of what is really in the public interest.

Ms. POVICH. Thank you. I wonder if I could get a comment from the panel about wage disparity and whether the current situation with the disparity in wages is leading to a shrinking or perhaps even an elimination of what we refer to as the middle class? If we can turn for the moment from the poorest of the poor case scenarios and the jobs training programs to the average Joe worker out there, is the situation with the wage disparity as we see it leading to the need of the middle class?

Mr. HARRISON. A much debated question. The best statement I can offer on this question at this moment is that the declining middle business is a complex combination of what's going on in the job market, demographic changes, and changes in Government fiscal policy that have affected who gets what kind of income. It's very messy, and all of the contributors to this debate, a number of whom are in this room, have not done a very good job of sorting out the pieces.

In the job market—and I'll be thrilled if nothing more comes out of this morning than that I've inadvertently gotten Marvin Kosters to agree publicly—the proliferation of low-wage jobs is a roughly accurate characterization of what's going on.

When you get to the level of family income, it gets more complicated because a lot of other things are happening. The growth of single parent households—the decline of marriage as a social institution—pushes the distribution toward the lower end. That yuppies tend to marry yuppies pushes the distribution in the other direction, toward the high end. The average white collar professional woman in the United States working as a programmer or an account executive or an insurance executive or whatever is not making all that much money, and there aren't all that many such people, anyway. The professional white collar big city family makes it if there are two programmers in the house—and maybe some additional capital income, to boot.

The tax changes of the last 5 years have resulted in a substantial increase in the amount of income coming from property. That means that the relatively small share of the population that has significant amounts of property is doing considerably better, vis-a-vis the rest of us.

So at the level of the family income distribution an argument may be made that it is literally polarizing. I'm not making that argument. I'm suggesting that other have made it and it's plausible.

But the story in the labor market is best characterized not so much as missing middles as a relative explosion of lower-wage opportunities. Whether they in the future will translate into better jobs for people is going to depend on changing some of those social structures that Mike Piore is talking about.

Ms. Povich. Your comments are making Audrey Freedman almost jump out of her chair. I think she would like to say something in response.

Ms. Freedman. This is really frivolous mathematics and silly relationships. We're worried because we're creating millions of low-wage jobs and in fact this makes the proportion of low-wage jobs "too" high in the economy. Your alternative apparently is that we shouldn't create so many low-wage jobs. We should just have a few high-wage jobs and not be creating the millions of jobs that we are creating.

We want to create jobs. We are creating jobs throughout the whole distribution and to decry the creation of millions upon millions of jobs because they are not paying $25,000 a year right now, working in a steel plant as a production worker, right now, is wrong.

We should be trying to create more and more and more jobs and create more and more and more self-dependence—independence—in the population so that we are a working Nation, not a Nation of some high-wage people and a lot of dependents. It's not good for America and it's not our style in the past and I wouldn't want it to be deplored now that we are creating jobs.

Ms. Povich. Mr. Kosters, you had something to add?

Mr. Kosters. This is just a very brief footnote. I think Audrey made the point pretty well. I'm willing to concede that we have created many low-wage jobs. I would only say that the arithmetic indicates that we have created an even greater proliferation of high-wage jobs, because average hourly earnings in real terms have been rising in recent years, in contrast to the late 1970's. So there must have been an even greater proliferation of jobs higher up in the wage distribution. Indeed, my data suggest that the greatest proliferation seems to have come in the middle of the distribution since overall dispersion has been declining.

Ms. Povich. Thank you.

Mr. Harrison. I want to say something to Audrey's last point. The alternative to a proliferation of low-wage work is not to protect a small number of high-paid steel workers jobs! She said that, I didn't. The alternative is to change the terms on which work is designed and wages are paid, to change the terms under which workers are employed. I can understand why Audrey's and Marvin's organizations would rather not discuss that. It's easier to depict me as a simplistic apologist for high wage factory workers. But that is simply an incorrect characterization of my position.

One can't possibly evaluate changes in the economy without introducing some set of value judgments and standards. That's what Bernie Anderson's whole argument was about earlier.

My concern is that, in the present political context, with the Federal Government's withdrawal from the debate about the structure of work and the distribution of income, of the sharing of employment creation across races and gender and so forth, the field has been left primarily to players who are acting primarily in terms of very short-term profit considerations. Mike has suggested what some of those short-term considerations are:

The short-term fix of getting the cheapest possible workers and driving wages as low as possible, minimizing the possibilities for on-the-job training and upward mobility, is socially destructive as well as greedy. From a long-term perspective of expanding the productive capacity and competitiveness of the American economy, we ought to be doing exactly the opposite.

Ms. POVICH. Thank you very much. I have a feeling that this topic could go on for a very long time, but unfortunately the time for this panel is about to run out. I'd like to thank all of our panelists: Ben Harrison, Marvin Kosters, Michael Piore, Audrey Freedman, Bernard Anderson, and thank you all for being with us this morning. [Applause.]

Chairman OBEY. Thank you, Elaine. We will now take about a 5-minute break.

[Recess.]

Chairman OBEY. If I could ask you to take your seats, we would like to stay on time.

Nobody likes welfare. Politicians don't like it. Liberals don't like it. Conservatives don't like it. The average citizen who bears the freight certainly doesn't like it and the people who receive it don't like it, at least that has been my experience with all of them that I've talked to over the years.

The question that we have to ask is simply this: How can the social welfare system become the first rung of opportunity instead of the last resort in a paternalistic arrangement between people who are on it and people who are footing the bill?

Frankly, I don't think that economists have focused enough on the problem. In a real sense, obviously, poverty is the absence of income, but it is something much more pernicious than that. It can be a personal tragedy. It can be a personal trap, and those tragedies and those traps spill over into frustration which really poisons the entire country's toleration of the problem.

Abled-bodied people who can work and who do not are people whose economic contributions are lost. They drain resources from other more productive uses. Those who lack training or education are far less productive and efficient workers and that means that their personal deprivation and their personal hardship hurts not just themselves but everyone else in the society.

Since productivity growth has become one Achilles heel of the American economy for the last decade, this is no small matter. There are a lot of questions we need to ask. In a time of budget austerity, how can we best target social welfare dollars? A smaller percentage of social welfare dollars goes to the most needy today than in 1978; and yet a non-means-tested universal program such as Social Security remains the most effective and pervasive way for alleviating poverty. Can we use the social welfare system as a way to create opportunity for those who most need it? Where do the working poor fit in? What do those on welfare really need to get off the dole and into the work world? How can we best prevent welfare dependency and what strategies have succeeded in breaking it?

Perhaps most importantly, what is the social welfare equivalent of preventive medicine? What policies inoculate families against prolonged welfare and which ones weaken their resistance? Last, how do we make reasonably certain that if we invest significant amounts in worker training that a job will really be there at the end of the process?

We have an excellent panel to explore those questions and others today and we also have an excellent moderator. Mike McNamee is an economics reporter for the Dallas Morning News who has previously worked for USA Today and I would ask Mike at this point to take it over and keep us on time.

PANEL: THE SOCIAL WELFARE SITUATION—MIKE McNAMEE, MODERATOR

Mr. McNamee. Thank you, Chairman Obey. We do have an excellent panel ranging from people who are administering welfare programs, experimenting with welfare programs, studying them, and all able to address these questions very directly. We will be starting with Gerald McEntee. He's the president of the American Federation of State, County, and Municipal Employees, the Nation's largest public employee union. He's president of the Public Employee Department at the AFL-CIO. He's been international president of AFSCME since 1981. Before that, he was quite an organizer of public employees in Pennsylvania with AFSCME Council 13, and a graduate of LaSalle College in Philadelphia.

PRESENTATION OF GERALD W. McENTEE

Mr. McEntee. Good morning and thank you for the opportunity of joining in this conference which is most certainly needed, not just here in Washington but all across the country.

I lead a union whose members administer America's welfare system. They handle the intake offices and they take all the abuse you can imagine one receives when you deal with desperate people on the bottom of America's economic system.

The social service and welfare workers who are part of the 1.1 million members of AFSCME complain bitterly about our antiquated welfare system, where recipients get next to nothing in a cycle of dependency and where working conditions—caseloads in West Virginia as high as 350—cause frustration and anger.

AFSCME members also see welfare from a number of other perspectives, many of them too close for comfort. Some of our members got their first real jobs and left the welfare rolls during the great expansion of State and local government from 1965 to 1975. Mercifully, only a few today find themselves back on the welfare rolls or, even worse, working off their welfare grants at their old jobs in the public sector.

While, fortunately, our members have been spared from the fate that's befallen hundreds of thousands of auto and steel workers, they know that Gramm-Rudman or another recession could put them in the same dire straits.

With the taxes they pay, they deplore a welfare system that fosters dependency. People want to work for a living. And our members believe that recipients who are able to work should be helped to get and to hold jobs.

But think how you would feel if you came to work one morning and you found that they had assigned somebody to work alongside you doing the same job that you do, but instead of being paid the same rate you're paid for your job, the new person was working off his or her welfare grant at the minimum wage rate.

The reality of 1986 is that public employees in New York, Pennsylvania, Michigan, Iowa, Wisconsin, and New Jersey face these workfare programs every day. And AFSCME has worked successfully to prohibit this kind of workfare job substitution in public employment because it's bad for welfare recipients, bad for public employees, and bad for public services.

The reality of 1986 is that workfare programs have still not been proven to be successful. For example, an evaluation of the California Experimental Workfare Program during Governor Reagan's first term found that the program didn't save money; it didn't reduce the welfare rolls by helping participants obtain regular employment; and it didn't discourage employable applicants from seeking other means of support.

An 1980 study of Massachusetts Pilot Workfare Program also concluded that the program was too costly and didn't help participants find jobs.

The Manpower Demonstration Research Corp., is now evaluating work and training programs for AFDC recipients in eight States across the country. Their preliminary findings on the San Diego Workfare Program, for example, indicate that only 18 percent of the participants found regular jobs while in the program. They also found that most of the workfare assignments did not result in skills improvements. Data are not yet available on whether or not those participants who made it from workfare to jobs were better off working than they were on welfare.

But unless they were the exception to the rule and got excellent fringe benefits at the minimum wage, chances are they were worse off. Rather than break a dependency on welfare, workfare reinforces it. Instead of providing an income, independence, and opportunity, it provides no income, degradation, and dispair.

Employable welfare recipients need real jobs. Fortunately, there are some Government programs that work effectively to move them from welfare dependency to work and opportunity. And our union has played a role in crafting some of them.

Massachusetts, we think, is the best example. There, welfare recipients with children are required to register for work and training and are given a reason to want to work. Not only do they have the opportunity to get regular jobs paying considerably more than welfare rates, but they can get the training, education, and support services to get those jobs. What's more important, they take a personal stake in their work by voluntarily selecting the career they want to get off welfare.

The data on the Massachusetts program are impressive indeed; 20,000 AFDC recipients have moved off welfare into unsubsidized jobs in a 2-year period. The Massachusetts welfare caseload has dropped by nearly 10 percent and the jobs are good starting jobs at an averge of $5 an hour—not deadend workfare jobs.

Unemployment in Massachusetts is under 4 percent, the post-war definition of full employment. Some of the program's success has to result from the States high employment rate. This program ought to be an advertisement for a full employment economy. It ought to be an advertisement for Federal support for State and local programs.

But what about a State with high unemployment and few job opportunities? To me, the answer seems clear. People need income support while they look for work or train for work. If there still is no work available, they should get the help they need to start a new career or to move to where they can get work.

Public employees—indeed all of the American labor movement—know the dangers of the economic course ahead of us. As you know, the trade deficit and declining productivity have already pushed too many workers out of the middle class and into minimum wage jobs or welfare dependency.

America's workers are eager to make the changes needed to achieve the goals of full employment and opportunity for all Americans. But they will not make those changes alone. And they will not accept the club of workfare and destitution as we attempt to rebuild our economy.

Equity and our national self-interest demand that we spend the money we need to break the cycle of poverty and welfare dependency. There is no reason why we can't educate, train and support our citizens while they learn the skills they need to become employed and self-sufficient. To do anything less is to fall into a dangerous cycle of national dependency and decline.

The 1980's and 1990's should be remembered as a time when all Americans joined together with govenment to fashion new solutions to build a full employment economy, a time when no one however unskilled and untrained, was consigned to workfare or welfare dependency.

In some of the states there are encouraging signs that Government, business and labor have begun the work that needs to be done. It's time now for Washington to do the same. Thank you.

[The complete presentation of Mr. McEntee follows:]

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Statement by

Gerald W. McEntee
International President

American Federation of State, County
and Municipal Employees

Before The

Congressional Joint Economic Committee Symposium
Panel on: "Moving from Welfare Dependency
To Work and Opportunity"

Friday, January 17, 1986, 11:00 a.m.

Caucus Room, Cannon HOB

in the public service

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o An evaluation of the California experimental workfare program during Governor Reagan's first term found that the program didn't save money; it didn't reduce the welfare rolls by helping participants obtain regular employment; and it didn't discourage employable applicants from seeking other means of support.

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In some of the states there are encouraging signs that government, business and labor have begun the work that needs to be done. It's time now for Washington to do the same.

Thank you.

Mr. McNamee. Thank you, Mr. McEntee. You've made the first part of my job easier by keeping your eye on the light and meeting your time requirement.

The audience can make the second part of my job easier by holding up your hand and a staff member will bring around a question card. Any questions you have for the panelists will be sent to the front just as they have been in previous panels.

The second panelist is Robert Kuttner. He's the economics correspondent of the New Republic magazine and has written extensively on matters of economic structure and our economic future in a column for Business Week and in the Atlantic Monthly. He is the author of two books, "The Economic Illusion" and "Revolt of the Haves."

PRESENTATION OF ROBERT KUTTNER

Mr. Kuttner. Thank you.

Not long ago I got a phone call from an assistant to the president of a Fortune 500 corporation. It was a speaking invitation and a lavish speaking fee was mentioned and she said, "Now tell me what is it that you speak about?" And I said, "Well, I'm interested in the state and the market." She said, "The state of the market?" I said, "No, the state and the market." She said, "Well, tell me more." I said, "Well, I'm interested in equity." She said, "Well, there must have been a misunderstanding. We wanted someone who spoke about equities." This happened.

I think there's too much concern with equities and not quite enough concern with equity and it's nice to be here in a forum where equity is at the forefront.

There's also an assumption that equities, the state of the private market, must flourish at the expense of equity, an assumption which I challenge. And there's a further assumption that the programs of Government which are all too frequently dismissed as the failed programs of the past are drags on economic efficiency and must be shunted aside in order for the private economy to flourish.

In my few minutes I want to recall some of the very successful opportunity programs of the past and to suggest that although the American experience is very strong on individualism and private initiative that public programs have often been a very useful ally in serving individual opportunity.

In recent decades the emphasis of these public programs have shifted somewhat from opportunity to security, from individual advancement to redistribution, and I think to some extent that's why they get into hot water. There is not a great deal of support in this country for the Government as an engine of explicit income redistribution. There is an enormous reservoir of support for Government assistance in promoting individual opportunity.

A safety net is a terrible metaphor. It's a metaphor that I tend to avoid and I think the rest of us would be wise to avoid. Because most people don't want to land in a net. Most people don't think of themselves as falling off the ladder and when you talk about safety nets it reinforces the idea that the welfare state is something for "them" and we all know who "them" is, rather than something for us.

Let's recall for a minute all of the ways that Government, the public sector, in the American experience has served as an ally of opportunity and let's think of what the needs are in the last quarter of the 20th century and how Government might again be converted into an ally of opportunity.

You can go all the way back to the colonial common school, even before the American Constitution was written, which was really the first radically egalitarian public program on behalf of individual opportunity. You can go into the 19th century and look at the homestead acts and the Morrill Act of the Civil War era, the whole concept of agricultural extension, even public subsidy of the railroads. These all served as often quite expensive opportunity programs mainly aimed at farmers and their families and really, if you think about it, America of the 19th century was spared the need to think very hard about redistribution. We were blessed with a lot of cheap land that we had taken from the Indians. The Indians were not part of our social contract. Government could serve as an ally of the aspirations of pioneers. And nobody worried very much about the Jeffersonian premise that Government which governs best governs least because Government was helping people.

Opportunity was seen as something individual and not social and really compared to the class-ridden nations of Western Europe the United States had it easy. We could have Government serve individual aspirations. We could have our equality and our individualism at the same time. There was no tension between individualism and social equality.

Well, as we all know, things have been rather different in the 20th century. Redistribution, which is a more ideologically charged issue, reared its head and yet even in the 20th century we've had a succession of opportunity programs, very successful programs, even though they were often expensive programs—programs like the GI bill of rights, an entitlement program that spent the equivalent of $55 billion in current dollars sending people who conventionally were not qualified to go to college back to college and universities. We had the Home Loan Bank System and the FHA and VA mortgages which I think quite eloquently contradict the assumption that markets always get us to where we want to go. If it hadn't been for the Home Loan Bank System and the FHA, the long-term self-amortizing low downpayment mortgage never would have been invented. If you recall the melodramas of the turn of the century where someone was on the railroad track because she couldn't pay the mortgage, that didn't mean the monthly payment; that meant a balloon note. That meant the whole thing was due because in those days, because Government hadn't invented it yet, there was no such thing as a long-term self-amortizing mortgage. The public sector taught the private sector how to do it and provided immense opportunities for a whole generation of people. Similarly, education grants and loans.

Now opportunity horizons look very different to different generations. Someone who was born around 1920 thinks of Government and he thinks of the New Deal programs that probably put his father back to work. He thinks of the GI bill. He thinks of his first house on an FHA loan. He thinks of Medicare. He thinks of Social Security.

Someone who's 25 years old looks at Government and tries to think of services that he's getting directly from Government and maybe the first thing that comes into the mind of that young person is the tax bill that he has to pay. Frank Levy and Richard Michel have done quite persuasive work for this committee showing the tremendous difference in life chances of different generations and it's no accident that that, in turn, is reflected in the political views of different generations about Government.

What would Government do in the 1980's if we didn't have to worry about Gramm-Rudman or if we could bring ourselves to increase taxes or perhaps chop away at the Pentagon? What are the opportunity needs of the 1980's and 1990's in the spirit of the homestead acts, free public education, the FHA and the GI bill?

I want to talk in my couple of remaining minutes about three areas.

First, the whole system of unemployment compensation and aid to families with dependent children which has been a dole system ought to be converted into an opportunity system. We spent $30 billion a year at the peak of the 1982–83 recession paying people not to work and not paying them very much not to work. The percentage of people without jobs who even get unemployment compensation is now below 30 percent.

We spend something like 80 to 90 percent of our labor market outlays paying the subsistence of the involuntarily idle.

It seems to me that rather than cutting that back further, we ought to expand it and redirect it as wage subsidies and retraining subsidies so that that money can go to create new jobs.

The Swedes, the one Western European country who have been at full employment since World War II, spend 3 percent of their total national income on wage subsidies and retraining and it has enabled Sweden to stay at full employment without having intolerable inflation.

Second, the great badge of membership in the American middle class is home ownership. Without going into great detail, since my time is almost up, we have immense subsidies proportional to how lavish your home is and how much money you earn. We ought to redirect some of those subsidies away from the "haves" and use them to subsidize first-time mortgages at below market rates for the "have-nots." We ought to do the same thing in rental housing and cooperative housing.

Finally, in the whole area of higher education, the Carnegie Commission's idea that we ought to get away from this shift to loans and go back to grants to subsidize tuition expenses but have those grants be paid back by a national service would create a generation of students who, instead of wondering how much money they can make to pay back all their indebtedness, they can pay back their indebtedness by serving society.

So I think the history of government opportunity programs is exemplary and once we can get beyond this short-term Gramm-Rudman madness we will see that there are a lot of opportunities for Government to serve individual opportunity and to serve it well. Thank you.

[The complete presentation of Mr. Kuttner follows:]

PRESENTATION BY ROBERT KUTTNER—THE PUBLIC SECTOR AND THE OPPORTUNITY ECONOMY

The Employment Act of 1946 grew out of a national commitment, late in the War, to put government on the side of economic security and opportunity. President Roosevelt's State of the Union Address of 1944 had outlined an "Economic Bill of Rights", including the right to a useful job, a decent home, adequate medical care, and a good education. Opportunity--the prospect of bettering one's economic condition--has always been at the center of the American experiment. Countless millions of Americans have advanced economically through their own hard work, and often with a boost from public programs.

Lately, the concept of opportunity has been appropriated by opponents of a constructive government role in the social economy. The newly fashionable premise is the ancient one of laissez faire: remove the fetters on personal creativity -- get the government out of the way -- and let individual opportunity flourish. This view reflects both a theory of economics and a philosophy of politics. Economically, it is in keeping with the premise that public programs are necessarily a drag on both overall economic performance and on individual initiative; politically, it suggests an radically libertarian civic philosophy: that "the governnent" is something on our backs, rather than on our side, and that in any case the debate seems mooted fiscally because deficit politics suggest that we can't afford new government programs.

In this paper, I want to recall the venerable history of public programs intended to enhance individual opportunity, and to suggest a theme for future uses of affirmative government. Although opportunity programs have often required a substantial government role and sizeable public outlays, they have been both popular and on the whole effective.

In recent decades the emphasis of government social expenditure has shifted from opportunity programs to programs of security and redistribution. Public security programs such as medicare, unemployment compensation or retirement pensions, and redistributive programs such as food stamps and AFDC can certainly be defended as a necessary "safety net", but they do not directly serve the bulk of the working age population. Thus, they represent a somewhat different philosophy and certainly a different politics. At present, the economic security programs consume the overwhelming share of the government's social outlays. While programs like social security and medicare remain broadly popular, younger age groups are increasingly skeptical about the return that they are likely to get from their social security taxes. It may well be that we need to refocus the role of social programs from security and redistribution to opportunity.

Antecedents

Although we typically think of government social programs as something invented only in the Great Depression, it is worth recalling that the American experience has used public outlays in the service of individual opportunity since before the American revolution. Free public education, invented in the 17th Century in the Massachusetts Bay Colony, was a very radical idea. It was the first government opportunity program. It was universal, local, and inherently egalitarian. The idea that citizens have an entitlement to education, independent of the size of their parents' purse, is still a radically egalitarian notion.

Similarly, in the 19th Century, the Homestead Acts of the Civil War era, the Morrill Act which established the first land grant colleges, the concept of agricultural extension, and even the public subsidy of the railroads, used the power of the state to enhance the economic opportunity of individuals -- in this case individuals who were mostly farmers and their families.

The American conceptions of equality and of the role of government in promoting equality are well represented in these early opportunity programs. Politically, the American Republic was predicated on the inherently egalitarian principle of one man, one vote. Socially, at least among the white population, there was no great problem of inequality of wealth undermining the egalitarian political principle, for the vast bulk of Americans were small freeholders. Nineteenth Century America was therefore spared a conflict that afflicted most European nations, namely the conflict between a political democracy and a class-ridden economy.

Economically -- and this is the crux of the matter -- most Americans saw opportunity as individual rather than social. They understood equality as equality of opportunity, not as the struggle of an entire class to win basic economic and political rights, as was the case in Europe of a century ago. In the American experience, therefore, the appropriate role of government was not to take from the haves and give to the have-nots, but to expand the horizons of the have-nots by facilitating their education, their access to credit, and to land.

In retrospect, the egalitarians of the early 19th century had it easy; they could have their equality and their individualism too. Land could be taken from the Indians, who did not vote and who were conveniently outside the egalitarian social contract; the concentration of industrial wealth was not yet a threat to a society where nobody was very rich or very poor. Philosophically, despite the Jeffersonian maxim "that government which governs best governs least", it troubled few people that government played a major role in these opportunity programs, because government was serving individual aspirations.

With the industrial revolution, the end of cheap empty land, the rise of robber barons, and the growth of urban poverty, the conception of equality and the issue of the appropriate role for government in enhancing opportunity became rather more complex and divisive. In place of the innocent, homely functions of providing free educations and farmsteads to aspiring pioneers, government was called upon to tax the rich, to subsidize the poor, to manage the economy, to regulate capital markets, to provide retirement security, to underwrite medical care, to create jobs, and so on. Equality, which had once been meant nothing more than an equal opportunity for indivudual advancement, had become a social question. Despite the egalitarian rhetoric of the American constitution and the dream of a broadly middle class society, plainly, the life chances of an unemployed urban school dropout were radically different from those of an industrialist's son. The consensus of the early 19th century about the American conception of equality and the appropritate role of the state, never even then quite as unanimous or simple as it now seems, was shattered.

And yet, even in the Twentieth Century, as government has taken on broader social functions, it has continued to enhance individual opportunies in ways that resonate with its older role. The government no longer gives away homesteads, but it sometimes helps to provide education and job training, which in an industrial economy are the economic equivalent of 160 acres.

Consider the G.I. Bill. In June 1944, President Roosevelt signed the "Servicemen's Readjustment Act", popularly known as the GI Bill of Rights. The original GI bill provided tuition payments up to $500 a year, and subsistence payments of up to $50 a month, which was inceased to $75 a month in 1948. During the twelve year existence of the original program, 7.8 million World War II veterans received subsidies for education and training: 3.5 million of them in vocational and technical schools, 1.4 million on the job, almost 700,000 in agricultural courses, and 2.2 million in colleges and universities. Although many prominent educators of the time opposed the virtual open enrollment of veterans, the typical supposedly underqualified veteran actually outperformed the average younger college student.
The total cost of World War II education and training under the GI bill was 14.5 billion, or something like $55 billion in current dollars. Another 2.4 million Korean War vets received training and education under successor legislation, at a cost of 4.5 billion.

The GI bill of rights had almost universal support, despite the fact that it represented a very sizeable government intervention into a largely private arena, higher education, and a very sizeable outlay of public funds. The reasons are not hard to discern. It was widely agreed that veterans had earned the benefits, by serving their country in wartime. The outlay was not considered a giveaway program, since it was serving the eventual self-sufficiency of the recipients. Thus, in both senses, the beneficiaries were considered "deserving". The program, significantly, was not income-tested. It was what we would now call an entitlement; to qualify, one only had to have served in wartime for at least 90 days.

In the same manner, the two notable housing programs of the era, VA-guaranteed home loans and FHA-insured loans, were almost universally supported. VA mortgages, initially at an interest rate of 4%, eventually served more than 11 million vets and their families. FHA loans served another 15 million families. Unlike the education grants under the GI bill, these programs were mainly loan guarantees, not subsidies, and they were also in the service of individual economic opportunity and advancement.

Higher education subsidies, which began in the Great Society era, can be considered part of the same tradition--public outlays to promote individual advancement. Under the present program of so called Pell grants, named for Senator Claiborne Pell, students from low or moderate income families can get grants of up to $2,100 per academic year, up to 50% of their total educational costs. Last year, some 2.6 million students benefitted from this program.

Like the GI bill and the guaranteed housing loans of the 1940s and 1950s, this program also enjoys wide support. The purpose is to promote individual advancement; the program is not criticized as a handout, for the recipients are deemed deserving. It is not a safety net, but a ladder of opportunity.

However, as federal social spending has come under increased budgetary pressures, Congress has de-emphasized student grants, and put greater reliance on student loans. A decade ago, in the academic year 1975-76, funding for grants and loans was about equal. By 1984-85, reliance on guaranteed student loans was about three times that of grants. As tuition expenses have outstripped family incomes, and as the minimum wage typically available to part time student jobs has lagged behind inflation, millions of young college graduates now enter the world of work saddled by educational debts. In the case of a graduate of a law school, or a medical school, the financial need to pay off a debt that can exceed $100,000 reinforces the tendency to look to high personal income rather than service to society.

Generational Perspectives:

Life chances, and the view of government as an ally of opportunity, can be strikingly different for different generations. Compare the perspectives of a man born in 1921, and one born in 1961. A person born in 1921, who is just at retirement age today, was a teen-ager in the great depression. He probably had the unsettling experience of expectations lowered as a young boy in the early 1930s. An early memory may be that of a father bringing home a paycheck from a public works job. He probably fought in World War II, and quite possibly got educated on the GI bill and bought a house with a GI loan. As he matured into midlife, and raised a family, he almost surely participated in the remarkable rise in real incomes between 1945 and 1973. During that period, he watched government provided tangible, useful things -- new public schools, an interstate highway system. And on reaching age 65, he will enjoy the benefits of medicare and an inflation-indexed social security pension far in excess of his lifetime social security tax contributions.

The opportunity horizons, and the role of government in promoting opportunity, seem radically different for the man born in 1961. Paradoxically, he was born into a far more affluent world than the older man; his family, in all likelihood, never experienced the steep reverses in economic status of the older man's family during the Depression.

But as the younger man enters the world of work, government as provider looms much smaller, and government as taxer looms much larger. Since 1973, real disposable income has not kept pace with inflation. As Frank Levy and Richard C. Michel documented in their recent paper for this committee, prior to 1973, the average man passing from age 40 to age 50 saw his real earnings increase by 30%. A man passing from 40 to 50 after 1973 saw his disposable income drop by 14%. Although overall taxation as a fraction of GNP increased only slightly between 1953 and 1980, the burden of those taxes changed dramatically--from corporate to personal, and from upper income to middle income. In 1953, the average-income family paid just 8.7% of its income in federal income and payroll taxes. By 1980, that had grown to 16.2%

As the younger man looks at what he buys for those taxes, he doesn't see very much that benefits him directly. There is unemployment insurance, if he finds a job and loses it, but there is no entitlement to job training; there are very high taxes to finance social security and medicare -- 14.1% of payroll compared to 3% in 1944 -- but social security retirement is forty-some years off and medicare does not cover the working population. All told, over 70% of the entire federal budget is now in just four categories--defense, social security, medicare, and interest on the public debt.

If the man is a college graduate, government may have helped with the tuition payments, but the help was more likely to have been a loan than a grant, and the loan payments are now due. On the housing front, there are no more cheap government loans, and virtually no more government subsidy of moderately priced houses. Even after the recent drop in mortage interest rates, an FHA or VA loan is in the 10-11% range. In the 1940s, a VA loan carried an interest rate of 4%, with no money down. Levy and Michel calculated that an average-income thirty year old could buy a median-priced house on just 14% of his income in 1949; by 1985, it took an astonishing 44%.

There are still the safety net programs -- AFDC if the young man fathers an illegitimate child; food stamps and medicaid if he finds himself in sudden poverty, short term unemployment compensation if he has a work history, but no entitlement to a job or to job training. And most of the working-age of the population does not receive safety net benefits. So it is not surprising that the present mood of the young is self-directed, and skeptical about government. A new political action group called Americans for Generational Equity -- "AGE" -- is founded on the belief that young, working Americans are getting a raw deal from government.

Our hypothetical young man born in the idealistic year 1961 may well to join the parade of voters who are increasngly cynical about government's ability to deliver much of anything besides bills from the tax collector. He may vote for the politician who favors IRAs over social security, because IRA's at least promise a tax deduction now, while social security may never deliver. He may well agree that safety net outlays should be cut back further, since welfare is something for "them", not for "us", and welfare often goes to people who don't deserve it.

But it is questionable whether generational equity and opportunity would be served by further cutbacks in public outlays. The trouble is that a market economy presents opportunities very unevenly. If the young man has an entrepreneurial bent, or inherited money, was lucky enough to have gotten an advanced degree in law, or medicine, or engineering, individual initiative will in all likelihood serve him fine. But if he is just an ordinary working American, without elite education, or family advantages, he may experience great difficulty finding a good job, good housing, and a rewarding career.

Government performs best when it serves opportunity. I suggest that governmnent needs to be redirected, not for the sake of restoring faith in government, but in order to use government as the engine of opportunity that it has so often been in the American experience. What, then, are the needs of the 1980s and 1990s, in the great tradition of opportunity programs stretching back through Pell Grants, and FHA loans and GI education, all the way to the Homestead Acts and the Massachusetts free common school? Consider three basic areas: post-secondary education, employment and training, and housing.

Education. As noted, the emphasis of federal aid to higher education had gradually shifted from grants to loans. This has occurred during a period when tuition costs have risen faster than disposible family income. In turn, it has has left a generation of students burdened with debt, and more concerned about short run financial prospects than about service to society.

Last year, Dr. Frank Newman, President of the Education Commission of the States, wrote a fine report titled "Higher Education and the American Resurgence," published by the Carnegie Foundation for the Advancement of Teaching. Taking note of the abrupt shift from grants to loans, Dr. Newman wrote: "The tradition of this country has been that the colleges and universities are the gateway to a student's future, that a determined and hard working graduate from a poor family starts out on an equal footing with other graduates. Today, not only is that student less likely to graduate, but if he does he is more likely to start out owing tens of thousands of dollars. That is hardly starting even."

Dr. Newman proposed a simple, egalitarian concept. College students would accept an obligation to perform two or three years of service, post graduation, and in exchange would receive grants of $3,000 per year toward higher education. High school graduates who did not attend college could perform civillian or military service, and receive tuition credits to go back to school, on the model of the GI bill.

Dr. Newman's specific proposal was for public service teaching fellowships. The required community service would be teaching in urban public schools. But the program could also reach a wider range of community needs. The value of this approach is that it leaves the new college graduate unburdened with debt, and thinking about how he or she can serve, rather than how much he or she can make. As part of the bargain, the student gets a college education, and the government gets needed community workers, in teaching, public health, and other difficult-to-fill fields. The young graduate also gets useful work experience, and a sense of service.

Employment. A second area where government has emphasized security to the exclusion of opportunity is job training and unemployment compensation. And lately, even the promise of security has fallen well short of the mark. Since 1935, we have spent close to two hundred billion dollars paying unemployment insurance claims, nearly $30 billion of it in the recession year 1982 alone. We have done little to assure jobs; and as budgets have tightened and eligibility has been cut back, needy people are left with neither employment nor income security. In 1985, the percentage of unemployed people receiving unemployment benefits fell below 30%.

When unemployment insurance began in the 1930s, the idea was to provide a 16-week bridge between the job that the worker lost, and some new job, either in the private sector or in a New Deal "work relief" project. Unemployment insurance was never intended to be a long term dole. By the same token, Aid to Families with Dependent Children, a creation of the same 1935 Social Security Act that gave us unemployment insurance, was intended as a program for people in exceptional circumstances. In the 1930s, the female-headed household was a rarity. The "normal" family included a breading winning father, and a mother who stayed home with the children. Dependent Children--the DC in AFDC--were seen as the consequence of unusual personal calamities, such as the untimely death of a father.

But during the postwar years, both of these programs evolved into grudging, long term sources of subsistence for large segments of the population. AFDC, however unintentionally, used income-support formulas that encouraged women, once on welfare, to stay on. The gradual cutback in medicaid, from a program that served the working poor to one that served only the welfare population, created yet another obstacle to moving from welfare to work. Large numbers of women bore children out of wedlock, and stayed on welfare as long as their children were at home, even though many wanted to work as soon as the children were in school. But the formulas and guidelines made it very difficult to improve one's final income position by forsaking welfare for work, and no transitional machinery existed.

By the same token, unemployment insurance grew from a short-term "bridge" to an income support mechanism that provided income for as long as 65 weeks during recessions, and even longer for some clases of workers deemed idled by foreign competition. In a society that supposedly prizes the work ethic, the policymakers never got around to devising the other two legs of the labor market tripod--a comprehensive approach to training, and a guarantee that jobs would be available. The manpower programs of the 1960s and 1970s had confused, diverse goals, and although some of them did train people, they were never part of a coherent system or strategy. A labor market approach that stressed jobs and job training would be far better for the citizenry, and far more defensible politically and as public policy.

Despite the present fiscal climate, one can identify the beginnings of a more dynamic labor market strategy aimed at re-employment rather than relief. In several states, including Massachusetts and Ohio, the state welfare program permits grant diversions to finance supported work. During a transitional period on a new job, a former AFDC recipient receives both a paycheck and a series of support services ranging from counselling to training to transportation to daycare. Transitional employment partnerships help convert a welfare check into a paycheck, and allow a transfer payment to be used dynamically, as a bridge off welfare and into a job.

In two states, California and Delaware, there are pilot efforts to do something similar with unemployment compensation. Federal law at present does not permit using unemployment insurance trust funds directly to subsidize employment or even transitional training, but California, for example, peeled off a seperate payroll tax equal to one tenth of one percent, and created a separate fund to finance an "Employment and Training Panel."

The California Panel works with employers to subsidize retraining of workers who have been laid off and who have run out of unemployment benefits, or workers who would be idled by technological changes unless retrained. The Panel has also helped subsidize efforts of employers to raise the quality of an entire workforce. One major retailer decided it needed a higher quality sales force. It upgraded pay levels from minimum wage to over $5 an hour, and used a short term subsidy from the Panel to pay for the training. An aerospace company used panel training subsidies to upgrade machinists to technicians qualified to program advanced, numerically controlled machining centers.

Most economists agree that this kind of subsidy makes economic sense because the failure of private employers to invest sufficiently in training is a classic case of "market failure". From the perspective of an individual employer, it is a waste to put money into training an employee, because they employee is then free to take his newly learned skills and go to work for somebody else. But if society pays some of that cost, everybody gains. The employee gets higher skills and better pay, and the employer gets a more productive workforce.

Another state, Minnesota, has used public funds to subsidize the costs of employment directly, through a program called MEED. During a transitional six month period, the state will pay up to $5.00 an hour of the wage and fringe benefit costs or all newly hired workers over and above the number of workers that were on an employer's payroll the previous year. The results have been very impressive. The retention rates exceed 60%--that is, employers keep most of their new workers onthe job even after the subsidy expires; and in the first two years the program produced 27,720 new jobs, returning to the state treasury $37.1 million that would have been lost if these tax-paying citizens had been remained idle.

These new labor-market approaches have two interesting characteristics in common. First, they use public income-support dollars dynamically, to get people into permanent jobs. Second, most of these jobs are in the private sector. Surprisingly, this approach was pioneered in Sweden. Most Americans think of Sweden as a fairly socialistic country best known for its comprehensive welfare state. But is no accident that the welfare state has such broad public support in Sweden, for the Swedes don't think of "welfare" as a dole, but as the means to a job.

Sweden's National Labor Market Board, the AMS, spends the equivalent of 3% of Sweden's entire national income putting people back to work. In America, the equivalent sum would be over $100 billion a year. And the bulk of this money goes not to pay for unemmployment checks, or even for CETA-style public works jobs, but to provide retraining and to subsidize the creation of new jobs in the private sector. This is the micro-economic counterpart of a macro-economic commitment to full employment.

This use of labor market funds to subsidize retraining and re-employment is a vast improvement over the two extreme alternatives of either guaranteeing a dole to idle people, or trusting to the harsh discipline and the uncertain outcomes of laissez faire. In recent years, public policy has cut back unemployment insurance benefits, and has continued to limit their use to subsidy of idleness. We should do the opposite, on both counts. Outlays need to be increased, and they need to be used flexibly, to subsidize retraining and re-employment.

Housing. Housing is a third area in which governnment once served to advance individual opportunity and mobility, but now public policy serves to widen the chasm between haves and have-nots. Under the current administration, direct subsidy of new low and moderate income housing construction has all but disappeared.

Instead, the principal public subsidy for housing is a tax subsidy, the unlimited mortgage interest deduction, which will cost other taxpayers an estimated $40 billion by 1988. This, too, is distributively and generationally perverse. An upper-middle income family, which bought a large house a decade ago, enjoys a substantial tax subsidy, as well as an inflation proof investment that is largely exempt from capital gains, and an out-of-pocket cost of housing well below that which could be purchased currently on the open market. Even worse, the subsidy is in direct proportion to the affluence of the taxpayer: the more lavish the house, and the higher the tax bracket, the steeper the subsidy.

A young family looking to buy a first home may well find itself paying thirty or forty percent of total income, while the family that bought years ago enjoys more house for far less outlay. We ought to be subsidizing the have nots, not the haves. Here intelligent public policy would cap the mortgage interest deduction at an amount reasonable to buy a basic "starter house"-- say the interest on a loan of $50,000. Taxpayers could continue to deduct that amount from their taxable income, but if they chose a more expensive home the additional mortgage interest would not be a tax deduction. This would save the Treasury some $7-8 billion. That money, in turn, could be used to subsidize a first-time mortgage of, say, 7%, for every new homebuyer. The below rate mortgage would be a one-time entitlement, good for the first five years of homeownership. This policy-shift would produce no net cost to the Treasury. But it would put government on the side of the family looking to buy its first house, rather than giving subsidies to the already well-off.

Similarly, in the area of moderate income rental housing, public policy has swung from doing nothing, to making extravagant commitments and expensive mistakes, and back to doing nothing again. Traditional public housing, with more than a million units built, is often unattractive, yet affordable housing is in such short supply that public housing continues to have long waiting lists. The subsidized for-profit low-income housing built in the 1960s and 1970s has been plagued by a very high failure rate. Local rent control, where it exists, is a very imperfect way of keeping an affordable housing stock, at the expense of private investors and often at the expense of new housing construction. Condominium conversion continues to deplete the supply of rental housing.

One alternative, which has been used very widely abroad, but scarcely at all in the United States, is called mutual housing. A mutual housing association is a kind of cooperative apartment complex owned by the residents, but insulated from ordinary market forces. A member of a mutual housing association is assured a decent housing unit at a moderate cost, secure from eviction or condominium conversion, but foregoes the opportunity to make a large captial gain if he chooses to cash out and move elsewhere. Membership in the association is kept at a very nominal cost, for the next member. Mutual housing is a hybrid between owning and renting; it offers the security of owning, but not the capital investment potential; it offers the low cost of rental, without the insecurity. Socially, it provides the benefits of rent control, without the adversary relationship between landlord and tenant. Economically, it "de-commodifies" a portion of the housing supply--that is, it removes it from the inflationary pressure of market forces, but without the inefficiencies of bureaucratic ownership and management.

Mutual housing has provided approximately one housing unit in three in postwar Germany. It also provides millions of homes in Scandinavia and in Canada. Recently, the Neighborhood Reinvestment Corporation, a non-profit public corporation chartered by the Congress, which sponsors Neighborhood Housing Services for single-family homes, has begun assisting mutual housing associations. This approach is well worth expanding.

I have proposed to put government outlays back on the side of expanding individual opportunities. In some areas, as in the tax treatment of mortgage interest, this might be accomplished by changing the pattern of present subsidies. But in other areas, such as the national service education idea, or the proposal to expand and redirect labor market outlays, this will require additional public expenditure.

This may seem implausible, at a historic moment when the main preoccupation of both parties and both the executive and legislative branches of government are cutting the federal deficit and reducing public spending. Yet if we fail to enlist government to promote economic opportunity, we will increasingly have a government whose main constituency is the old, the sick, the isolated poor, and the military; we will have a truncated party system where both parties are the party of anti-government, and an electorate who has forgotten what affirmative government can accomplish.

Although that seems to be the current course, I doubt it will remain the case for very long. For government has proven itself time and again to be a very useful ally of economic opportunity. The trick is to align the functions of government with the contemporary aspirations and needs of the broad public. That is what must be done before the voters will entrust government to undertake opportunity ventures as bold as the GI bill, the FHA, the nineteenth century homesteads and the colonial common schools.

Mr. **McNamee**. Thank you, Bob. I especially enjoyed your description in your paper of the World War II veteran who got the VA loan and so forth and so on and is now saying, "By God, we don't need the Government. Let's get rid of these programs." I see that in my own family.

Our third speaker is Prof. James Gwartney, professor of policy sciences at Florida State University. He's written extensively and done a great deal of research on issues of poverty and income and he's testified on that research frequently before this Joint Economic Committee.

PRESENTATION OF JAMES GWARTNEY

Mr. **Gwartney**. Thank you, Mike.

I'd like to express my appreciation to the chairman and the leadership of this committee for the opportunity to speak to you today. This 10-minute limitation is something that's difficult for a professor to adjust to. As I look out over the audience I see some other professors and most of us are sort of used to you wind us up and we talk for 50 or 60 minutes. So it's really going to have to cramp our style today.

To begin with, I'd like to think with you on the lessons that we might learn from the last 20 or 25 years with regard to transfer payments and efforts to assist individuals with low incomes. While there's been a great deal of research in this area, it has often been contradictory, as not only this panel but prior panels have indicated. But it does seem to me that there are a few things that we have learned that there is some agreement upon over the last 20 years.

The first of those it seems to me is we have learned that low income persons or the poor if you want to use that expression, are a heterogenous group. I oftentimes like to think of it as if you've really got—again, this is an oversimplification—two sort of general classes of poor. First there is what we might refer to as the hardcore poor, the primary individuals in this group are persons with various kinds of handicaps or disabilities and the elderly, who as a result of age, are no longer in the work force. Various kinds of market incentives are going to exert relatively little impact upon the poverty status or income status of the hardcore poor.

But there's also another group. I've used the term marginal poor to describe this group. There's evidence this group is at least as large and probably larger than the former group. The marginal poor are constantly moving in and out of poverty status, sometimes a little above, sometimes a little bit below. In fact, a great deal of the research that has been done on AFDC as well as poverty status, of which Mary Jo Bane is one of the leading contributors, shows this mobility—this in and out status of lots of people in this category.

So in terms of our thinking about persons with low incomes, it's important to keep in mind that you've got these two groups. The kinds of strategies that will work for the one may be totally ineffective for the other.

I think we've learned something else over the last 20 or 25 years. This may be a little bit more controversial, but it seems to me that there's a great deal of agreement in the economics profession on this. It is much more difficult to assist low-income people by income transfers than what we previously thought. Transfers create side effects. Looking at it in a more general framework, it is necessary when you make income transfers that you establish some kinds of strings or constraints if you like in order to ration those transfers.

If you didn't establish these constraints, the transfer would completely eat away the total budget, indeed the total size of the economy. So in a world of scarce resources you have to establish constraints on transfers. That is true for any kind of transfers that we might talk about, not just transfers related to low-income status.

But the very act of establishing the restraints tends to reduce the value of the transfer to the recipient. In order to continue receiving the transfer, for example, in the case of means-tested transfers, you have to continue maintaining a low income. If your income increases, then the size of the transfer is reduced. In the case of the unemployed worker, you have to continue nonemployment status in order to receive the transfer.

So as a result, the value of the transfer to the recipient will be a great deal less than the gross cost of the transfer to the taxpayer.

A third factor we have learned over the last 20 years that's very important in interpreting where we should go is that the experience of the elderly and the nonelderly are decidedly different. The set of charts that was prepared for this conference by the Joint Economic Committee illustrates this point. If you look in back of the chartbook, there's a chart on the poverty rate. While there's some fluctuation in it, it will show that the overall poverty rate declined rather sharply until say around 1970. It leveled off during the 1970's, and then rose slightly during the 1980's.

Now if you look at the case of the elderly, it's quite different. All that time the poverty rate decreased even in the 1980s. But if you broke that chart out and looked at persons under 44 years of age or the entire nonelderly group, you would find that the poverty rate of a nonelderly has been increasing since the late 1960's. It's not something that's just a relatively recent occurrence, it's something that's taken place over a long period of time.

So as a result—I think it's interesting thinking back to my second point—that you see the criteria, the restrictive device in the case of the elderly is age. That's something that the adjustments that we make, whether we like it or not, we can't do very much to affect when we're going to be 65 and whether we're 65 or not. So the value of the transfer is not reduced by that restrictive device.

But in the case of transfers to the nonelderly, you have other kinds of restrictive devices that result in very high implicit marginal tax rates. If you earn additional income, the value of your transfer is reduced.

Well, what does all this add up to in terms of the directions that we ought to go? My yellow light is already on so I'm going to have to make those much shorter than what I indicated in the paper. It seems to me that there are two things that are crucial here.

First, in the case of the nonelderly or what I'm calling the marginal poor it's clear that work elements need to be more important in terms of our future programs. We need to be experimenting and thinking about how we can make work a substitute for other restrictions limiting the transfers. The second thing that's very crucial here is that we need to devise programs so that the marginal tax rate that low-income people face is certainly no higher than a person who makes $100,000 of income would face during a year. And I might add, the current programs are not successfully accomplishing this objective.

[The complete presentation of Mr. Gwartney follows:]

New Directions in Antipoverty Policy:

Lessons from the Past and Guidance for the Future

by

James Gwartney*

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New Directions in Antipoverty Policy: Lessons from the Past and Guidance for the Future

The purpose of this paper is to analyze the record of tax-transfer policy during the post-War in Poverty era and to consider alternative policies that offer promise of success. The paper will show that the poverty rate of working-age adults has been increasing since the late 1960s. The reasons for this increase will be analyzed. The nature of the problem of poverty has changed substantially during the last 25 years. These changes will be discussed and their implications for current policy considered. Finally, the paper proposes a number of reforms designed to reduce the incidence of poverty and improve the earnings opportunity for low-income Americans.

I. Income Transfers and Poverty Rates — The Historical Record

During the 20 years following World War II, substantial reductions in the incidence of poverty were achieved through economic growth. Between 1947 and 1965, the poverty rate of families fell from 32.0 percent to 13.9 percent. The progress was across the board. All age, racial, and family status groupings showed dramatic reductions in poverty. In less than one generation, the poverty rate had been cut in half. In the mid-1960s, it was widely believed that tax-financed income transfers from the non-poor to the poor would accelerate the decline in the poverty rate. Both policy makers and most social scientists accepted the position.

The 1964 Economic Report of the President presented the dominant view. The Report stated:

> The conquest of poverty is well within our power. About $11 billion (approximately $36 billion measured in 1984 dollars) a year would bring poor families up to the $3,000 income level we have taken to be the minimum for a decent

> life. The majority of the nation could simply tax themselves enough to provide the necessary income supplements to their less fortunate citizens. The burden — one fifth of the annual defense budget, less than 2 percent of GNP — would certainly not be intolerable.[1]

Between 1965 and 1975, there was a dramatic acceleration in the growth of income transfers. As Exhibit 1 illustrates, total cash transfers accounted for 7.5 percent of personal income in 1965, up only slightly from 6.2 percent in 1947. By 1975, the cash transfers had jumped to 14.1 percent of personal income. As a proportion of income, cash transfers had doubled in a single decade. Measured in inflation-adjusted dollars, the cash transfers nearly tripled as they soared from $132.9 billion in 1965 to $344.2 in 1975 (1984 dollars).

Of course, a large proportion of total cash transfers reflect the growth of social security and unemployment compensation payments. Thus, they were not specifically targeted toward the poor. However, it is clear that there was also a dramatic growth of targeted antipoverty transfers during this period. Measured in 1984 dollars, means-tested cash assistance rose from $18.3 billion in 1965 to $34.5 billion in 1975. Means-tested noncash transfers increased sevenfold from $5.7 billion to $38.2 billion between 1965 and 1975. Total means-tested real transfers (1984 dollars) tripled, jumping from $24.0 billion in 1965 to $72.7 billion in 1975.

While expenditures on means-tested cash assistance actually declined during the 1975-1984 period, this decline was more than offset by continued growth, albeit at a slower rate, in noncash benefits. By 1984, total means-tested expenditures in real terms were nearly three and one-half times the 1965 level.

Did the increase in transfer expenditures and expansion of government antipoverty programs accelerate the decline in the poverty rate as was widely anticipated during the mid-1960s? Incredible as it may seem, almost the opposite occurred. Except for the

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Exhibit 1: Growth of Transfer Payments, 1965-1984
(Billions of Constant 1984 Dollars)

Type of Benefit	1947	1965	1975	1980	1982	1984
Total						
Transfer Payments						
Billions of Dollars	$54.4	$132.9	$344.2	$375.1	$404.5	$416.9
Percent of Personal Income	(6.2)	(7.5)	(14.1)	(13.8)	(14.6)	(13.8)
Means-tested						
Cash Assistance (in billions)[a]	NA	$18.3	$34.5	$32.1	$29.3	$28.8
Noncash, means-tested	NA	5.7	38.2	49.2	50.5	51.5
Food stamps	NA	0.1	8.5	11.0	11.0	10.7
School lunches	NA	NA	1.6	1.9	1.9	1.8
Public housing	NA	1.1	4.4	5.7	5.4	5.7
Medicaid	NA	4.5	23.7	30.7	32.2	33.3
Total, means-tested	NA	24.0	72.7	81.3	79.8	80.3

[a] Includes Aid to Families with Dependent Children, General Assistance, Supplemental Security Income, and Means-tested Veterans' pensions.

Source: U. S. Department of Commerce: Bureau of the Census, Estimates of Poverty Including the Value of Noncash Benefits: 1984. Table A, and Economic Report of the President, 1985.

elderly, progress against poverty came to a grinding halt shortly after the mid-1960 acceleration in the growth of transfers. As Exhibit 2 illustrates, the poverty rate for the elderly has fallen consistently throughout the post-War period. The official poverty rate of persons 65 and over declined from 30.0 percent in 1959, to 16.5 percent in 1970 and on to 7.3 percent in 1984.

The continuous decline in the official poverty rate of the elderly has pulled the overall poverty rate downward and thereby helped to conceal the experience of working-age Americans. In spite of the growth in means-tested transfers, the poverty rate of non-elderly adults has been increasing since the late 1960s. For families headed by a householder under 25 years of age, the official poverty rate rose from 13.2 percent in 1968 to 21.8 percent in 1980. By 1984, the poverty rate of these youthful families had jumped to 29.4 percent, a poverty rate substantially in excess of the 1965 rate of 19.4 percent. Similarly, the incidence of poverty among families headed by persons age 25-44 rose from 9.3 percent in 1968 to 11.8 percent in 1980 and 13.2 percent in 1984. Families headed by a person under age 45 now account for nearly two-thirds of the poor families in the United States. The poverty rate of households headed by a person age 45 to 54 also rose from 7.0 percent in 1968 to 7.6 in 1980 and 8.6 percent in 1984. Thus, reversing the trend of the 20 years following World War II, the official poverty rate of working-age Americans has been increasing during the last 15 years.

The official poverty rate considers only cash income. It does not take into account noncash, transfer payments (in-kind benefits such as food, medical service and housing). Because the noncash benefits have grown so much more rapidly than cash transfers since the inception of the War on Poverty, some analysts have argued that the official rate is a misleading indicator of changes in the number of families living in poverty. Recent refinements by the U. S. Department of Commerce shed light on this issue.

The Commerce Department now provides data on the poverty rate adjusted for noncash benefits for the 1979-1984 period. Given the size of the noncash transfers and the impact of the in-kind benefits on the adjusted poverty rates in recent years, a poverty rate adjusted for noncash benefits can be reconstructed for earlier years.[2]

Exhibit 2 also presents data for the adjusted poverty rate by age.[3] The 1965, 1968, 1970, and 1975 adjusted data are reconstructed (via the method explained in footnote 2), while the data for 1980 are from the Commerce Department. While the adjusted rates are lower, the time path pattern is quite similar to that for the official rate. As for the official rate, the adjusted poverty rate of the elderly declined sharply throughout the period. By 1984, the poverty rate of the elderly adjusted for non-cash benefits had fallen to 4.3 percent, down from 15.9 percent in 1968 and 22.4 percent in 1965.

Once again the picture is quite different for working-age families. Between 1968 and 1980, the adjusted poverty rate of families headed by a householder under 25 years of age rose from 12.3 percent to 18.8 percent. By 1984, the adjusted rate for this youthful group reached 26.8 percent, well above the rate they experienced during the mid-1960s. For families headed by a householder age 25-44, the adjusted poverty rate rose from 8.6 percent in 1968 to 9.5 percent in 1980 and 11.4 percent in 1984. The adjusted poverty rate for the 45-54 age grouping was also greater in the early 1980s than in the late 1960s.

Thus, whether one looks at the official or adjusted poverty rates, the picture is the same. Except for the elderly, soon after the massive increase in transfer payments in the late 1960s, the steady progress of the pre-War on Poverty era came to a halt and the poverty rates of working-age Americans began to rise. Throughout the post-World War II period, real GNP has continued to rise (see Exhibit 2). However, since the late 1960s, real economic growth has not been translated into poverty-reducing income gains for the poorest working-age segment of our population.

II. Why Haven't Income Transfers Been More Effective?

In policy analysis, it is important to recognize that individuals will adjust their actions in light of policy decisions. Thus, policies often generate secondary, unintended

Exhibit 2: The Official Poverty Rate and the Poverty Rate Adjusted for In-Kind Benefits for Families by Age of Household Head, 1947-1982

Age of Household Head	1947	1959	1965	1968	1970	1975	1980	1982	1984
Per Capita Real GNP	$3263	$4076	$4782	$5271	$5393	$5702	$6480	$6370	$6925
Official Poverty Rate									
Under 25	45.0	26.9	19.4	13.2	15.5	21.0	21.8	26.1	29.4
25-44	27.0	16.5	12.8	9.3	9.5	10.3	11.8	14.2	13.2
45-54	27.0	15.0	9.6	7.0	6.6	6.6	7.6	8.9	8.6
65 and over	57.0	30.0	22.8	17.0	16.5	8.9	9.1	9.3	7.3
All Families	32.0	18.5	13.9	10.0	10.1	9.7	10.3	12.2	11.6
Adjusted Poverty Rate[a]									
Under 25	n.a.	n.a.	19.0	12.3	14.2	18.7	18.8	24.0	26.8
25-44	n.a.	n.a.	12.5	8.6	8.5	8.5	9.5	12.3	11.4
45-54	n.a.	n.a.	9.5	6.7	6.1	5.8	6.2	8.0	7.4
65 and over	n.a.	n.a.	22.4	15.9	14.9	6.0	5.4	5.5	4.3
All Families	n.a.	n.a.	13.7	9.3	9.2	8.1	8.2	10.2	9.8

[a] The poverty rate adjusted for in-kind benefits is based on the recipient value method of valuing noncash benefits.

Source: The 1947 data are from Economic Report of the President: 1964 (Table 7). The other data are from U. S. Department of Commerce: Bureau of the Census, Estimates of Poverty Including the Value of Noncash Benefits: 1979 to 1982 and Estimates of Poverty Including the Value of Noncash Benefits: 1984 affects. Sometimes these unintended side-effects conflict with the primary objectives of the policy. Such is the case with the current structure of transfer programs. The programs create an incentive structure that makes it more difficult for the poor to help themselves and benefit from general economic prosperity.

There are five major secondary effects of transfers that undermine their effectiveness as an anti-poverty weapon.

1. The transfers lead to higher explicit tax rates for the nonpoor and implicit tax rates for the poor, and thereby reduce the incentive of both to produce and use resources wisely. Since marginal tax rates determine allocation of income between an individual (or family) and the tax collector, they exert a particularly important impact on the incentive to earn and use resources efficiently. High marginal tax rates, both explicit and implicit, reduce the share of additional income the individual is permitted to keep. Thus, they weaken the link between productive activity and earnings. They also encourage tax shelter activities, the underground economy, and inefficient use of scarce investment resources. In short, high-marginal tax rates reduce positive-sum economic activity and economic growth.[4]

Some of the burden of higher marginal taxes levied against the nonpoor will actually fall on the poor in the form of higher prices, reduced employment opportunities, and lower after-tax wages. However, the most destructive effects stem from the high implicit marginal tax rates that accompany means-tested transfer programs. The benefit levels derived from programs such as AFDC, food stamps, medicaid, school lunch subsidies, and rent supplements decline as recipient income expands. Thus, recipients are only allowed to keep a small portion of any additional income they earn.

The implicit marginal tax rate associated with individual programs appears to be reasonable. For example, food benefits are reduced by $30 for each $100 of monthly earnings up to $800. The implicit marginal tax rates associated with cash transfer programs such as AFDC and unemployment compensation are higher, typically in the 50%

to 60% range. However, the marginal tax rate for any given program conceals the true picture. Most poor people who qualify for one program are also eligible for others. When the implicit marginal tax rates associated with each of these programs are considered together, the compound multi-program implicit marginal tax rate is very high.

For example, as Exhibit 3 shows, a mother with two children and no earned income residing in Pennsylvania would qualify for annual cash and in-kind benefits of $7,568 from AFDC, food stamps, Medicaid, and the Earned Income Tax Credit. If the family's earnings rose to $2,000, transfer benefits would be reduced and taxes increased, leaving the family with spendable income of $8,391. Thus, additional earned income of $2,000 generates only $823 in additional spendable income, equivalent to a marginal tax rate of 58.8 percent. At higher levels of earned income, this implicit marginal tax rate is even greater. If earned income rose from $3,000 to $5,000, spendable income would decrease from $9,214 to $7,694, an implicit marginal tax rate of 252 percent! If income increased further to $6,000, the family would decrease again, this time by $246. In fact, a family earning $6,000 has less spendable income than a family with no earned income, and a family earning $10,000 each year, equivalent to a full-time year-round job paying $5 an hour, would have spendable income of $9,229, just $1,661 more than a family with no earned income at all. The loss in transfer benefits and the increased taxes when earnings rise from zero to $10,000 is equivalent to a tax rate of 83 percent on earned income. Clearly, such high implicit marginal tax rates pose a significant disincentive to work and earn for those individuals whose potential earnings are relatively low.

2. **Since the current transfer system severely penalizes productive effort by the poor, the net increase in the income of the poor is much smaller than the transfers.** The high marginal tax rates accompanying means-tested transfers encourage the poor to substitute nonmarket time for work. Simultaneously, the increase in income derived from the transfers encourages the consumption of nonmarket (some would say leisure) time. Thus, traditional economic theory indicates that both the "substitution" and

Exhibit 3: The Effect of Transfer Benefits and Taxes on the Incentive of A Pennsylvania Mother with Two Children to Earn Income (September 1983)

Annual Gross Wage	Transfer Benefits[a]	Income and Employment Taxes[b]	Spendable Income	Implicit Marginal Tax Rate
$0	$7568	$0	$7568	-
2000	6525	134	8391	58.8
4000	5482	268	9214	58.8
5000	3040	346	7694	252.0
6000	2059	611	7448	124.6
7000	1719	810	7909	53.9
8000	1378	1021	8357	55.2
9000	1038	1240	8798	55.9
10000	698	1469	9229	56.9

[a] The following benefits are included: AFDC, Earned Income Tax Credit, Food Stamps and Medicaid. The Medicaid benefits were valued at the 1978 national average adjusted for inflation between 1978 and 1982.

[b] Includes social security and federal and state income taxes.

Source: Data are derived from U. S. House of Representatives Committee on The Ways and Means, Background Material on Poverty (Washington, D.C: Government Printing Office, 1983) Table 10, page 89.

"income" effects of the transfers will encourage the poor to reallocate time from market work to nonmarket activity (including housework, leisure, and perhaps the underground economy). Many transfer recipients who would otherwise have engaged in market work will decide to work fewer hours or not at all. As a result, some portion of the transfer income is merely replacement income; it simply replaces income the recipient would have earned in the absence of the transfer. Thus, the net income of recipients increases by less than the amount of the transfer.

Is there evidence that transfers have influenced the work force participation of the poor? Exhibit 4 presents data related to this question. Prior to the late 1960s, the number of householders with income below the poverty level who did not work at all during the year was declining. In 1970, there were 2.3 million household heads with income below the poverty level who did not work at all during the year. By 1980, the parallel figure jumped to 3.1 million and by 1984 it had risen to 3.7 million. Thus, since 1970 there has been a 59 percent increase in the number of poor householders who were not engaged at all in market work. In 1984, 50.6 percent of the poor household heads did not work during the year compared to 30.5 percent in 1959.

One might think this rather dramatic increase in nonwork by poor household heads merely reflects the decline in male household heads among the poor. Such is not the case. The work force participation of female household heads exhibits the same pattern. In 1966, 52.7 percent of the poor female households were out of the labor force during the entire year. By the early 1980s, the figure had jumped to more than 60 percent. By 1984, there were 2.2 million poor female householders who did not work at all during the year, compared to 1.0 million in 1966, an increase of 129 percent in 18 years.

Viewed from the perspective of employment, in the mid 1960s nearly half (47.3 percent) of the poor female household heads worked at least part of the year. By 1984, only 37.5 percent of the poor female householders worked during the year and only 7 percent worked full-time, year-around. At a time when the work force participation of

Exhibit 4: The Increasing Number of Poor Household Heads Who Do Not Work At All

Families with income below the poverty level	1959	1966	1970	1980	1984
All Poor Households					
Householder Did Not Work at all during the year					
Number (in millions)	2.5	2.4	2.3	3.1	3.7
Percent of Poor Households	30.5	39.7	44.0	49.6	50.6
All Poor Female Headed Households					
Householder Did Not Work at all during the year					
Number (in millions)	1.1	1.0	1.1	1.8	2.2
Percent of total	57.1	52.7	56.6	61.5	62.5

Source: U. S. Department of Commerce, Money Income and Poverty Status of Families and Persons in the United States: 1984 (Table 18); Characteristics of the Population Below the Poverty Level: 1982 (Table 5); and U.S. Statistical Abstract: 1968, p. 330.

females was rising, the rate for poor females was declining sharply. This is certainly consistent with the view that much of the transfer income was merely replacement for income that otherwise would have been earned had the incentive structure not encouraged nonwork.

3. *Skill depreciation is a secondary effect of the decline in work force participation of the poor with the passage of time. Declining skills further limit the ability of the poor to escape poverty.* When the poor opt out of the work force, their skills tend to depreciate. Individuals who have not utilized their skills for extended periods of time will find it difficult to compete with otherwise similar individuals who have continuous labor force participation. The long-term consequences of an incentive structure that encourages nonwork is even more destructive than the short-term effects. As marginal poor people opt for nonwork, their work record deteriorates. With the passage of time, they become less and less able to support themselves. No doubt, some would even find it difficult to readjust to a structured eight-to-five schedule which is generally necessary for work force participation. As the length of time out of the work force expands, marginally poor individuals move into the hardcore poor category.

If we do not institute a change in policy direction, what will happen to the 3.7 million poor household heads who did not work at all during 1984? Many of these people are capable of self support. However, if we continue to allow even their limited skills to depreciate, they will soon face a hopeless situation. No doubt, it is already too late for some. The nonwork trend illustrated by Exhibit 4 is an ominous sign for the future.

4. *Transfer programs based only on income reduce the cost of choosing a high risk life-style that increases the likelihood of poverty.* Some people end up poor because they failed to complete school, or because of drug or alcohol abuse, or because they have chosen to bear children without the means to provide adequate support. These individuals have made choices that severely limit their ability to be independent and self-supporting.

In effect, the transfer programs act as an "insurance" policy against adversity over which the marginal poor have some control. In this sense, the programs encourage the very situations that they were designed to combat. In the insurance industry, this is referred to as the "moral hazard problem." Recognizing this problem, private insurance companies seldom offer protection against "adversities" that are substantially affected by the behavior of potential policyholders.

Existing government transfer programs attempt to reduce the severity of the moral hazard problem by adopting detailed rules and guidelines intended to limit abuse and to promote legislative intent. The regulations however, eliminate the possibility of solutions tailored to each individual recipient which would in fact minimize moral hazard. Indeed, the regulations encourage potential recipients to alter their behavior so as to meet program eligibility requirements rather than to make choices that would reduce or eliminate their need for income transfers.

Surely the rising poverty rate among youthful Americans reflects the availability of government support for those who choose high-risk life-styles (involving, for example, sexual promiscuity or drug or alcohol use) that families often refuse to subsidize. The availability of government transfers has also made it less costly for husbands in low-income households to desert and for unmarried fathers to avoid responsibility for their children. Interestingly, there is one eligibility requirement for government transfer benefits that cannot be satisfied by a change in an individual's behavior: age. Therefore, moral hazard is not a problem in programs for the elderly. This helps explain why, alone among age groups, the poverty rate for those over 65 has continued to decline during the War on Poverty era (see Exhibit 2).

5. **The current transfer system reduces the constructive involvement of family, friends, churches, and other private organizations.** The best excuse to do nothing is the perception that someone else is already doing the job. Predictably, private individuals will do less when they think the government is doing more. During the 1960-1980 period,

literally millions of Americans perceived that increased government involvement relieved them of personal responsibility with regard to the poor. Many churches even shifted from person-to-person assistance to lobbying the government for more funds for antipoverty programs. Just now, as the failure of government programs to alleviate poverty is more readily observable, we are beginning to see a reawakening of voluntary action. Increasingly, we are again beginning to see civic groups supporting soup kitchens and churches opening homes for children and missions for the so-called street people.

The assistance of families and friends is probably the most important form of voluntary assistance. Unfortunately, the nature of such assistance makes it virtually impossible to quantify. However, it is possible to obtain data on the organized charitable giving of individuals, corporations, and foundations. Exhibit 5 presents such data, measured in 1983 dollars, for the 1955-1981 period. Annual charitable giving for religious purposes more than doubled during the 1955-1981 period. Private donations for education, and health and hospitals tripled during the same period. In contrast, charitable giving for social services (primarily directed toward the poor) was virtually unchanged during the period. As a proportion of private charitable giving, contributions for social services fell from 23 percent of the total in 1955 to 10 percent in 1981.[5]

The decline in private charity is particularly unfortunate since voluntary efforts are in a much better position to deal with the moral hazard problem. Thus, private efforts are likely to accomplish far more per dollar of expenditure. As private efforts are crowded out, once again there is an offset to the direct gain emanating from the transfers.

III. The Nature of Poverty in the 1980s

No area of social science has been the subject of more research than poverty during the last two decades. Much of the research in the area was hastily prepared, poorly designed, and ideologically biased. Nonetheless, there is general agreement among researchers on three important factual points concerning the nature of the problem in

Exhibit 5: Individual, Corporate, and Foundation Donations for Social Services and Other Purposes, 1955-1981 (in billions of 1981 dollars)

Year	Social Services	Religious	Education	Health & Hospitals	Other[a]
1955	$5.2	11.3	2.5	2.0	1.6
1965	5.4	18.8	6.5	4.2	3.5
1975	5.3	21.8	6.7	7.5	8.9
1981	5.3	24.9	7.5	7.4	8.6

[a] Including arts and civic programs.

Source: The data are from Russell D. Roberts, "A Positive Model of Private Charity and Public Transfers," Journal of Political Economy (February 1984).

the 1980s. I believe that researchers of most all persuasion would accept these three points.

Point 1: There is considerable movement into and out of poverty The poor are not a stationary populace. In fact, there are two rather distinct groups of poor people: (1) the hardcore poor characterized by long-term poverty status generally due to personal misfortune (e.g., debilitating disease, or physical, mental, or emotional disability) and (2) the marginal poor who temporarily fall into poverty as the result of factors such as a loss of job or a change in family structure. Since the marginal poor are a considerably larger group than the hardcore poor, the composition of the poor is constantly changing. Changes in the composition of the poverty population has been measured most precisely by a detailed study conducted by the University of Michigan's Survey Research Center.[6] This longitudinal study followed a representative sample of households during the ten-year period 1969 to 1978. The study found that a surprisingly large number of Americans (24.4 percent of all households) were poor during at least one of the ten years. Simultaneously, the study also verified that most people remain poor for only short periods, usually one or two years. More than three-fourths of the poor households were poor for only a few of the ten years (four years or less). Only 5.4 percent of all households were poor for five or more years during the 1969-1978 period. Less than one (0.7%) percent of the households were poor during all ten years.

These findings are highly consistent with prior research on Aid to Families with Dependent Children.[7] The major studies in this area indicate that nearly half of the AFDC recipient periods last less than one year. In contrast, only 16 to 18 percent last five years or more. Once again, we see the two groups, the temporary marginal poor and the long-term hardcore poor.

Point 2: In contrast with the situation 25 years ago, today families headed by a working-age adult now account for the overwhelming majority of the poor. In 1959, the problem of poverty was interwoven with aging. As Exhibit 6 illustrates, the elderly

THE ELDERLY AND NONELDERLY AS A

PROPORTION OF THE POOR

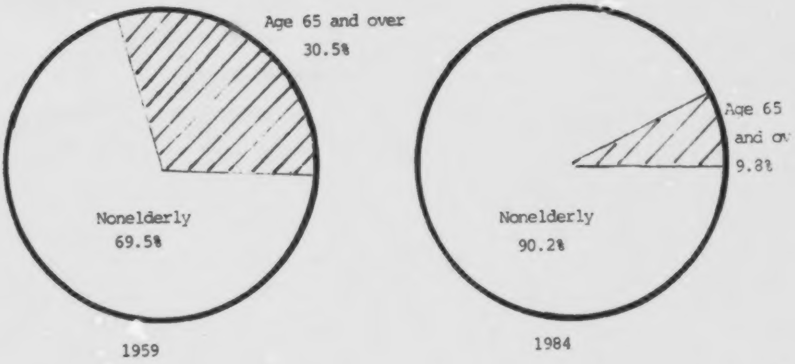

Exhibit 6: The Elderly and Nonelderly as a percent of All Poor Families, 1959 and 1984

Source: Economic Report of the President: 1964 (Table 10) and Current Population Reports, Money Income and Poverty Status of Families and Persons in the United States: 1984. (Table 18).

accounted for nearly one-third of the poor families in 1959. Twenty-five years ago, the incidence of poverty among the elderly was substantially greater than for other age groupings.

Today, the picture is dramatically different. The elderly account for less than one-tenth of the poor families. The incidence of poverty among the elderly is lower than for any other age group. When one accounts for noncash benefits, the adjusted poverty rate of the elderly is less than half the rate for prime working-age adults. In the 1980s, progress against poverty will require an improvement in the income and earnings of low-income, working-age adults.

Point 3: In the 1980s, the problem of poverty is interwoven with changes in the family structure. In 1959, three-fourths of all poor families were traditional husband-wife families. Only 17 percent of the poor households were single-parent families headed by a non-elderly female (see Exhibit 7). Once again, the last 25 years have wrought a dramatic change. In 1984, less than half (49 percent) of the poor families were traditional husband-wife families. Families headed by a female under age 65 accounted for 45 percent of the poor households in 1984, more than two and one-half times the proportion in this category in 1959. Most of the children living in these families have either seen their parents go through a divorce or they were born to an unwed mother.

Exhibit 8 illustrates the association between changes in family status and poverty. Here we present the findings of Mary Jo Bane and David Ellwood on the events that triggered the beginning and ending of AFDC recipient periods. Bane and Ellwood found that three-fourths of the periods on AFDC were triggered by one of two events: (1) a divorce/separation or (2) birth of a child to an unmarried female. Change in family status (either marriage or children leaving the home) accounted for 46 percent of the AFDC periods ending.

Researchers are continuing to debate whether income transfers contribute to family instability. There is some evidence on both sides of this issue. It is true that the

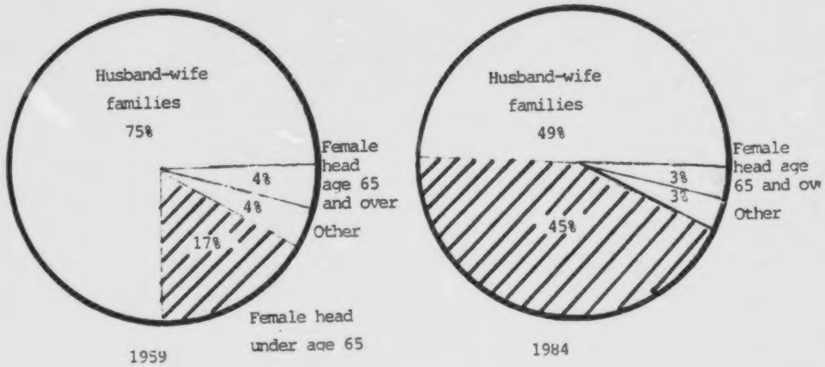

Exhibit 7: The Increasing Proportion of Poor Families Headed by a Working-age Female

Exhibit 8: Changes in Family Status and Beginnings and Endings of Periods of AFDC Dependency

Event triggering the beginning of a period of AFDC recipient status (percent distribution)		Event triggering the ending of a period of AFDC recipient status (percent distribution)	
Divorce/Separation Childless, unmarried woman becomes a female head with children	45%	Marriage	35%
		Children leave	11
Earnings of female head fell	12	Earnings of female headed increased	21
Earnings of others in family fell	3	Earnings of others in family increased	5
Other income fell	1	Transfer Income Increased	14
Other (including unidentified)	9	Other (including unidentified)	4
All	100%	All	100%

Source: Bane, Mary Jo and Ellwood, David, "The Dynamics of Dependence and the Routes to Self-Sufficiency," Final Report to the U. S. Department of Health and Human Services. Cambridge, MA: Harvard University, Kennedy School of Government, 1983 and Ellwood, David T. "Targeting the Would-be Long Term Recipient of AFDC: Who Should be Served?" Preliminary Report, Harvard University, 1985.

divorce rate, incidence of female — headed households, and births to never-married females have accompanied the general rise in welfare transfers. However, the linkage is a weak one, and it may not be the result of a cause and effect relationship. Since the impact of transfers on family status is most likely to be long-run and cumulative rather than immediate, sorting out cause and effect relationships in this area is particulary difficult. However, we must not allow this debate to divert us from an important point. Regardless of whether transfers contribute to family disintegration, the decline of the family changes the nature of the problem. Proposed solutions must bear this point in mind.

IV. New Directions in Antipoverty Policy

If antipoverty public policy in the 1980s is going to be effective, it must (1) profit from past errors and (2) recognize the current nature of the problem. Additional funding for current programs will do little to improve the economic status of the poor. A new direction is needed. The new direction must rely more on providing income from work and less on income transfers. An incentive structure that encourages working-age, low-income households to climb on the earnings ladder is essential. This means the extremely high implicit marginal tax rates accompanying the current programs must be reduced and they must be reduced substantially.

The new direction must rely more on making people accountable for their choices and less on insuring individuals against the consequences of irresponsible actions. The traditional family is a vital weapon against poverty and it must be strengthened, rather than weakened. This means fathers must not be allowed to use divorce and separation as a means to escape financial support for dependent children. It means single-parent mothers must work even as most wives of traditional families now do. It means the tax burden on low-income, dual-workers families must be reduced.

The new direction must rely more on private charity and less on government programs to deal with the problems of able-bodied adults. Private action is better suited to provide assistance without generating harmful secondary effects. Future government policies must recognize this point.

To this end, I would propose six reforms consistent with the nature of the problem in the 1980s. These reforms would reduce the current upward trend in the poverty rate of working-age adults.

Reform 1: Require the states to adopt a work requirement for all able-bodied, non-elderly recipients of public aid. This would mean that heads of households receiving AFDC, food stamps, medicaid, and housing subsidies would be required to work full-time (perhaps defined as 32 hours or more) at either private employment or a public sector job. No exception would be made for the presence of children in the home. The current concept of long-term public assistance to those who do not work was developed during a different environment. For men, it arose during the massive unemployment of the Great Depression; for women, it originated prior to the movement of large numbers of married women into the workforce. Today, half of all married women with pre-school children and two-thirds of those with school-age children are in the labor force. Many of these working women are among the marginal poor. No doubt, many of these women in traditional husband-wife families would like to stay home and give more time to their children. How can we justify asking them to work and pay taxes to finance transfer payments so others can stay home with their children?

A work requirement would substantially alleviate the negative long-term effects on the poor emanating from the skill depreciation and moral hazard effects, as well as much of the abuse of the current system. The workforce participation would help the poor develop and maintain elementary skills, such as getting to work on time, structuring their lives to fit an eight to five workday, and understanding instructions. With the passage of time, other skills capable of providing self-sufficiency market incomes would be developed. Simultaneously, a work requirement would take a lot of the luster out of the youthful attraction of having a baby, being your own boss, and heading your own household.

Two major objections are generally raised against a work requirement: There are few jobs the poor could do, and it would be necessary to provide child care services. These objections suggest the nature of the work requirement. A substantial proportion of the new low-skill "employees" would provide the labor force for the child care centers. This would minimize their costs. While their skills are modest, it is simply not true that the poor are unemployable. Many would be able to occupy beginning level service, clerical, and operative jobs. With time, their skills would improve and movement up the job ladder would be possible. At least this approach would halt the skill-depreciation effect accompanying the current programs.

There are several ways that child care service might be structured. State and local governments might provide the management for child care centers. Alternatively, the government might simply allow public aid recipients to work at a nominal cost for private providers of child care services. Because we do not know what arrangement is likely to work best, this reform should be carried out at the state level. States will experiment with alternatives and the most successful methods of instituting work force/child care provisions will be emulated.

Reform 2: Substitute an economical, nutritional food plan for the food stamp program. The food stamp program provides low-income households with purchasing power for food, but it does not necessarily provide nutrition. Since food stamps can be used to purchase such a broad range of goods, strict income limits are required. High implicit marginal tax rates (an additional 30 percent under current law) are a necessary side effect of the strict income limits.

Under my proposal, food stamps could be used to purchase only a limited set of nutritional food items and the income limitation would be raised substantially. I recommend that no more than ten economical, nutritious food items, (such as rice, potatoes, navy beans, dried fruits, dried milk, soybeans, grain breads and baby formula) be eligible for purchase with food stamps.

My proposal has two major advantages over the current food stamp program. First, it would provide the poor with a more nutritious diet while minimizing the abuse of the program. Since nutritional food stamps could neither be used to purchase junk food nor be traded at anything near face-value by irresponsible poor parents, my plan would substantially increase the likelihood that poor children would actually receive adequate nourishment. Simultaneously, this plan would reduce abuse by the quasi-poor. Non-poor going through transitional periods (e.g., relatively well-off retirees or youths shifting from schooling to part-time employment) that would permit them to qualify for assistance would be much less likely to do so since the nutritional plan would mean eating rice and beans, rather than potato chips, cokes, and cheese dip.

A second major advantage of the nutritional food plan with a higher income limitation would be a lower implicit marginal tax rate. Exhibit 9 indicates how the proposed nutritional food plan would differ from the current food stamp program for a family of four. Essentially, the current food stamp program provides a family of four with $250 (approximately) of monthly benefits which are reduced by $30 per $100 of net monthly earnings. Thus a family with $500 of monthly net income would receive food supplement assistance of $100. The assistance cutoff under the current plan is $833 (approximately) of net monthly income.

Under the proposed plan, a family with zero income would receive $180 of assistance. Given the economical nature of the nutritional goods, this should provide even a family with zero income as much nourishment as the current program. Most importantly, under the nutritional plan, the benefits are reduced by only $15 per $100 of net monthly income. Thus, a poor family of four with $500 of monthly net income (approximately what a single earner would make at the minimum wage) would receive $105 of benefits compared to only $100 under current legislation. For all net income level between $500 and $1200, even the dollar value of the food assistance would be greater under the nutritional plan.

Exhibit 9: The Schedule of Food Benefits for a Family-of-Four, Current Versus Proposed Plan

Net monthly income-family of four	Current Program		Proposed Nutritional Program	
	Food Stamp Benefits	Implicit Marginal Tax Rate	Benefits	Implicit Marginal Tax Rate
0	250	30%	180	15%
200	190	30	150	15
400	130	30	120	15
500	100	30	105	15
600	70	30	90	15
800	10	30	60	15
1000	0[a]	-	30	15
1200	0	-	0[a]	-

[a] The net monthly income level associated with the cut off of benefits is approximately $833 under current law compared to $1200 under the proposed plan.

The nurtritional food plan slices the implicit marginal tax rate confronting the poor from 30% to 15%. Clearly, the program would make it easier for the working poor to provide for themselves. Even though the program has a higher income cut off than the current program, it would almost surely cost less. This result stems from the lower expected participation rate among the quasi-poor. Since the nutritional stamps can be used to purchase only a limited set of goods, it can be anticipated that many qualifying families who are not really poor will pass up the plan (or use it less intensely). Essentially, the nonpoor will choose to eliminate themselves. This is one of the desirable attritutes of the plan.

In summary, the nutritional plan will improve the diet of the poor, substantially reduce their implicit marginal tax rate, and result in less abuse by the nonpoor. It is in the interest of both the poor and the taxpayer.

Reform 3: Increase the Personal Exemption Allowance to $2000. Under current tax laws, a family of four with taxable earnings of 15 percent less than the poverty threshold is subject to an explicit marginal tax rate of 11 percent. Thus, the personal income tax further reduces the incentive of the poor to provide for themselves and their families.

In contrast, the $600 personal exemption of 1959 meant that working poor families did not pay income taxes. In 1984, prices were 3.6 times the level of 1959. If the 1959 personal exemption had been indexed for inflation, it would have been equal $2,140 in 1984 (rather than $1000). Between 1959 and 1984, per capita personal income rose by 470 percent. Yet the personal exemption increased by only 67 percent (from $600 to $1000). Failure to increase the personal exemption has bought marginal income tax rates to the poor. If we really want to help the poor help themselves, surely we want to remove the disincentive of taxation. Raising the personal exemption to $2000 would accomplish this objective.

Reform 4: Eliminate all favorable treatment of single-parent households relative the two-parent households as a qualification criteria for public aid. Antipoverty efforts should reinforce, rather than undermine, the traditional husband-wife family. Means-tested, benefits should be linked strictly to income, not single-parent status. If a family with a single parent qualifies for benefits, so should a married couple family of equal size and income. This is not always the case. For example, children in families with only a single-parent now qualify for public aid (AFDC) even though children in a traditional husband-wife family of equal size and income do not. Similarly, many states provide medicaid benefits to single-parent families, while excluding the benefits from married couple families of identical size and income. The era of subsidizing single parent families shoud be brought to an end.

Reform 5: Policy should make fathers of dependent children more accountable for their support. Too often, youthful mothers and the taxpayers are left with the responsibility of a child, while the father can successfully escape his obligations. Our institutions need to let males know that fathering a child is serious business. Strict enforcement of court mandated child support payments is a step in this direction. Recent moves by both state and federal authorities allocating more resources to the enforcement of child support payments is commendable.

However, additional action is needed. Currently, only about half of the fathers mandated to provide child support payments are providing benefits at the court-awarded level. Approximately 30 percent are providing no benefits at all.[8] There are several steps that could be taken to make fathers more accountable for their actions. We could require the fathers of dependent children under 18 to pay a surtax (of 2 percent for example) if they are not making child support payments. Certainly, fathers of dependent children should lose their eligibility for transfers such as subsidized educational loans, food stamps, and medicaid. Such action would let fathers know that they will be held accountable for their dependent children.

Reform 6: Transfer policy should rely more extensively on the voluntary organizations such as churches, civic groups, and other private charitable organizations to deal with difficult cases that may fall through the cracks. One of the most harmful side-effects of expanded government antipoverty involvement has been its negative impact on private charitable action. Just now, as the failures of government programs become more readily observable, we are beginning to see a reawakening of voluntary actions.

By way of comparison with government programs, private actions have two major advantages. First, private individuals and organizations have the capacity to structure help for the poor in ways that minimize the moral hazard problem and avoid harmful disincentive effects. Private aid can be tailored more exactly to the specific needs of the individual or family and structured so as to elicit efforts by the poor to help themselves. Second, since the sacrifice of the donor is far more visible under voluntary charity, recipients are much less likely to take the aid for granted and more likely to respond positively to it. These are enormous strengths that must not be lost. They will permit private action to accomplish more with fewer resources.

Government antipoverty efforts should focus on the hardcore poor, those with mental and physical handicaps. The marginal poor, particularly those who are poor at least partially as the result of their own choices (e.g., school dropouts, youthful mothers, and drug users) should be left to voluntary action. Private action is more suitable to deal effectively with these difficult cases.

CONCLUSION

The current approach to welfare is geared primarily toward helping people once they get into trouble. Effective reform must be directed more toward the prevention of trouble. The current approach is geared toward meeting the minimum needs of the poor as long as they stay poor. Effective reform must be structured so as to encourage the poor to make better use of their productive skills as a means of escaping poverty. The current approach is designed to alleviate the consequences of irresponsible, poverty-causing decisions. Effective reform must discourage such irresponsibility, and rely more heavily upon voluntary action which is better suited to deal with the moral hazard problem.

New directions in this area are critical. The current approach has failed. More dollars will not solve the problem. The problem continues to fester, not because we are failing to do enough, but rather beause we are doing so much that is counterproductive. Significant progress can be made, but it will require that we break out of our current mold of thinking about this problem and redirect antipoverty efforts toward helping the poor escape from the grasp of the current programs.

[1] Economic Report of the President: 1965 (Washington: Government Printing Office, 1964, p. 77.

[2] Mathematically, the adjusted poverty rate within age group a for each year i is equal to:

$$APR_{ai} = OPR_{ai} - \frac{MTE_i}{MTE_{80}}(OPR_{a80} - APR_{a80})$$

where APR_{ai} = adjusted poverty rate during i year within age group a
OPR_{ai} = official poverty rate during year i within age group a

MTE_i = noncash, means-tested expenditures in year i

MTE_{80} = noncash, means-tested expenditures in 1980 base year

OPR_{a80} = official poverty rate within age group a in 1980 base year

APR_{a80} = poverty rate within age group a in 1980 base year

[3] The recipient value method values noncash benefits at the equivalent amount of cash income a recipient would be willing to exchange for the right to the noncash benefits. Thus, it takes into account that recipients might rather have cash than the in-kind benefits. It is widely accepted by economists as the most appropriate method with which to impute a value to the noncash benefits.

[4] See Dwight Lee (ed.) Capital Formation and the Deficit Economy, San Francisco: Pacific Institute, (forthcoming 1986) for evidence on this point.

[5] See Russell A. Roberts, "A Positive Model of Private Charity and Public Transfers" Journal of Political Economy, February, 1984.

[6] Greg J. Duncan, et.al., Years of Poverty, Years of Plenty. Ann Arbor: Institute for Social Research, 1984.

[7] See June A. O'Neill, et.al., Analysis of Time on Welfare (Washington, D.C.: Urban Institute, 1984) and Mary Jo Bane and David T. Ellwood, "The Dynamics of Dependence: The Routes to Self-Sufficiency" (Report to U.S. Department of Health and Human Services, Harvard University, 1984.

[8] See U.S. Statistical Abstract — 1982-83, p. 344.

Mr. **McNamee**. Thank you, Professor Gwartney. I know you feel that the 10-minute limit is crimping your time but all the panelists so far have done much better than most Members of Congress I've seen. They use the same light system and just ignore it.

Chairman **Obey**. If I could just interject, I would remind you, however, that most Members of Congress at least on the House side are limited to the 5-minute rule.

Mr. **McNamee**. Our fourth panelist is Jack Meyer. He's the director for health policy research, American Enterprise Institute. He has also served in Government as Assistant Director of the Council on Wage and Price Stability, Director of the HUD Office of Special Studies, and special consultant to the Ford Foundation project on social welfare. Since everyone today is going to talk about Gramm-Rudman, I should point out that it's two AEI alumni who were administering those cuts the other day and maybe we should blame Mr. Meyer for this.

PRESENTATION OF JACK A. MEYER

Mr. **Meyer**. I'd like to start by asking how a government that spends about a trillion dollars a year as ours does leaves so many unmet needs and how a government that seems to have spent about one-fourth more than it takes in year after year cannot fashion a way out of that mess—and it is a mess—in anything other than a heavy-handed, imbalanced and, in my view, unfair approach known as Gramm-Rudman.

It seems to me the answer has to do with Americans' ambivalence about Government. I think they are rather contradictory about it and, indeed, a little greedy. The fact is, we want lower taxes, but we still want all of our benefits, and this is true of the rich, middle income, and poor alike.

The heart of the problem of helping people with real needs involves the poor targeting across the budget. In fact, many receive who don't need and many need who don't receive.

Whenever we talk about meeting some unmet needs either within our welfare system or by extending our welfare system to those millions of low-income individuals whom it does not cover, people come forward and say we can't afford it.

It is true that we can't afford it if we are unwilling to nick ourselves and to contribute somewhat. Then we can't afford it.

I want to mention a few inequities across income categories since we're talking about income distribution today, and also some inequities within the poor that are known to many of you.

Let's talk first about inequities across income categories. Most of our social programs, the social insurance programs in particular, provide benefits that are not differentiated at all according to need and they are the most expensive programs. Indeed, the non-targeted, nonmeans tested programs account for four-fifths of Government spending for social programs.

Now I am not advocating means testing social insurance programs. I am suggesting that we consider in both defense programs and social insurance programs some cuts that might make room for assistance to those who are truly needy. It seems to me that there are ways to gear the subsidies that go to the elderly, veterans, farmers, and others somewhat to need, or to scale the contributions they make to their own insurance policies somewhat more to need, so as to make room for some other helping networks in our society.

For example, consider Medicare. The first-day deductible for hospitalization is $492. The elderly have to pay that out-of-pocket. For the wealthy elderly household, that's affordable. For a near-poor widow who can't get the Medicaid match, that's quite a problem. Yet they all pay $492 this year. They all paid $15.50 last year for their part B insurance. That was trivial for some and significant for others.

I think we have a double standard about Government on both the tax and expenditure sides. We bring to the welfare area the green eyeshade of prudent purchasing, and that's good. People like Mary Jo and others around the country administer State programs where we're looking for the last dollar of waste. But, can we really say that we're also applying standards developed in a $7 to $8 billion program like AFDC to a program 37 times as great, the defense program? Are we exercising the kind of prudent purchasing there? What's sauce for the goose is sauce for the gander.

I believe in being tough on the budget, but not in an imbalanced way.

Similarly, we cut taxes in our country for almost all income groups. I say almost. Not the poor. The poor's taxes, according to a study by the House Ways and Means Committee, rose from 4 percent of income in 1978 to about 10.5 percent last year. If the tax bill passed by the House last month is enacted, it would alleviate that problem, but we haven't seen that yet.

Let me mention a few horizontal inequities among the poor. In the chairman's home State of Wisconsin, the payment standard under AFDC is $636. At least that was the 1985 figure reported by the House Ways and Means Committee. The corresponding figure in Mississippi was $120 or about one-fifth as much. Indeed, I just completed a study of the State of Tennessee which showed that when the payment standard is looked at instead of the need standard, a household of four person has to have less than $2,016 per year to be eligible for any welfare payment. That's one-fifth of the Federal poverty line. We also find that in Wisconsin you can have up to $16,000 a year and meet the need standard, but in Tennessee it's about $6,400 a year.

So in one State you can have 1½ times the poverty threshold and be eligible for benefits. In another State you can have about two-thirds of the poverty level and be ineligible. This simply is unfair. When you consider that being ineligible for AFDC means that you lose Medicaid, of course, then the inequity is greater.

Let me just wrap up in the next few minutes by saying a word about health care which we cover in our paper, and let me add that my coauthor, Marion Lewin contributed heavily to this paper and it's a joint effort. I'm giving the remarks today. We view health care as a microcosm of poor targeting. At the same time that only about half the poor are eligible for Medicaid, we dish out tax preferences related to health care in this country that amount to more than the Federal Government spends on Medicaid. In fact, the fiscal year 1986 budget of the administration estimated a revenue loss of $31.6 billion for this year related to the exclusion of employer contributions to health insurance, but Prof. Alain Enthoven of Stanford, in recent testimony before the Congress, says that the foregone revenue is much higher, and in the range of $40 to $50 billion per year.

These subsidies on the tax side go mainly to middle and upper income households, and they're worth more to you the more you're worth. The higher your bracket, the bigger your tax subsidy. Yet when people like myself propose putting some ceiling on this subsidy and using the proceeds to fill in some of the gaps in our safety net, it runs into tough political sledding because you're asking upper income and middle income workers to give a little bit.

It also favor such steps as taxing more of Social Security benefits and taking a hard look at civil service retirement, which provides benefits more generous than those found almost anywhere in the private sector. In how many industries can you retire at age 55 with full benefits? Not many. How many industries provide full COLA's annually in their pensions? Not many.

Let me close by saying my concern about this imbalance is that we are mortgaging our future. I predict to you as I sit here today that the Congress will be forced to eliminate programs like the Job Corps in the coming year by the sheer arithmetic of Gramm-Rudman. Not because there's hard evidence that this program didn't work, and not because it is so expensive—indeed it would be lost in a rounding error of the defense budget or the HHS budget—but because there's no room for it when we circle the wagons around the defense programs or the social insurance programs. It will be sacrificed along with our investment in public infrastructure, along with education and other opportunity programs, which just happen to be called discretionary and just happen to be targeted to those people who have the least clout in this town. They're not part of the safety net. They don't receive AFDC and Medicaid. They may be ineligible because they're working at a $3.35 an hour job or a $4 an hour job. They are struggling to do the best they can. They may need an education loan or a training program or some little help that we might devise for them for a billion or less, but somehow, we just can't seem to afford it.

So I would close by saying let's take a look at the whole budget. I believe if you look across it you will see plenty of opportunities for fair cutting that would make room for the help that millions of Americans still need. Thank you.

[Applause.]

[The complete presentation of Mr. Meyer follows:]

POVERTY AND SOCIAL WELFARE

SOME NEW APPROACHES

A Paper Prepared for the
Joint Economic Committee on the
Occasion of Its Fortieth Anniversary

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Poverty and Social Welfare Policies:
Some New Approaches

Jack A. Meyer and Marion Ein Lewin

Introduction

Social welfare policy in the U.S. is now on a dangerous path. Our elected officials are succumbing to the temptation to circle the wagons around a set of retirement programs and national defense, shielding them from the long-overdue fiscal austerity that is finally beginning to occur in the federal government. The result will be a total withdrawal of the federal government from a wide variety of other efforts, a withdrawal that abandons many of our neediest citizens.

We face a dilemma today in social policy. The government programs that are the *most expensive* are also the *most popular*. Thus, to cut them is to risk the wrath of voters. Yet, to decide never to cut them is to abandon hope that the federal budget can be brought under control while still providing needed assistance to the disadvantaged.

By contrast, a whole slew of federal programs apart from retirement and defense will be jettisoned under current federal mandates. These programs are less popular, and can be cut without much short-term political fall-out. But, these cuts will not yield us much. In short, we're taking the easy way out; protecting sacred cows and slaughtering weak lambs.

These trends have been developing throughout the 1980's. The Gramm-Rudman-Hollings bill, enacted in December 1985, solidifies them. And, the demographic trends on the horizon, interacting with current fiscal priorities, threaten to strand the economically and socially disadvantaged, and write them off, while weaving a protective cocoon around subsidies that are poorly targeted. In short, we are promising to continue to dish out help to the non-needy precisely as we turn our backs on the needy. Our lack of political courage will not be without victims.

In the first part of this paper, we highlight some of the tradeoffs and conflicts in our overall social welfare policy. This section analyzes the distribution of the burden associated with recent policies designed to hold down federal spending, and suggests ways to improve the balance and fairness of budget cuts. The next section focuses specifically on public assistance programs targeted to low-income households, with a particular emphasis on health care.

Background

How did we get ourselves perched on the horns of this dilemma? First, we relied too exclusively on centralized federal programs to solve our social problems. Some of these federal programs have been highly successful, while others have foundered. In the process, however, local efforts to solve social problem--public and private--were often eclipsed. Second, we put ourselves in a bind through highly irresponsible fiscal policy. Quite simply, we have elected and re-elected people who have catered to our public wishes to obtain more government aid than we are willing to pay for.

The result-- a government that is consistently spending about one-fourth more than it takes in. Fortunately for our children, we cannot run our household budgets for very long in this fashion.

Unfortunately for our children, the federal government can run its budget this way for a rather long period of time. The most dangerous part about this deficit financing is that its deleterious effects can be masked for years. There is a long latency period, but the illness, however obscured from view, will ultimately be virulent.

As we entered the 1980s, the growth in federal social spending that occurred over the previous 15 years was losing its political mandate, and would soon lose its revenue base. Does this mean the American people were ready to tighten their belts on the benefit side in order to have a leaner, meaner government? Don't believe it. The resounding 88 to 0 vote against President Reagan's first proposal to cut Social Security, featuring a reduction in the early retirement benefit from 80 to 55 percent of full benefits, was a signal of public sentiment on this score.

Furthermore, it is fair to say that this Reagan proposal was an exception to the general thrust of his social policy. President Reagan really did not set out to cut non-means-tested entitlements providing benefits to all economic groups. The administration had no real game plan for controlling Medicare, military and civil service pay and benefits, or veterans payments in 1981, and it retreated hastily on Social Security after the initial defeat.

Moreover, the administration's early proposals for cutting Social Security and Medicare were not responsive to the need to shield current beneficiaries, particularly those with lower incomes, and concentrate on long-term changes that slow the automatic growth in benefits. And, in the early 1980s, Congress certainly had no game plan of its own for the entitlement programs.

We wanted tax cuts-- and we got them. But we refused to "pay" for them through commensurate controls on outlays. The cuts that were made fell disproportionately hard on those who could least afford them. Many well-to-do people got a free ride. And, a mountain of federal debt piled up.

The Effect of New Legislative Thrusts

The Gramm-Rudman-Hollings bill at least has the virtue of addressing, finally, the unconscionable deficits that threaten our future. We do not question its basic goal or the aggregate targets. But, the distribution of the sacrifice required by its timetable is very skewed. The exemptions and virtual exemptions built into this legislation will force the Congress to take a meat ax to some segments of the budget while protecting the majority of spending from even a glancing blow.

Of the roughly $970 billion in the FY 1986 budget, an estimated $705 billion, or 73 percent of total federal spending, is exempt from cuts under Gramm-Rudman. This includes a large chunk of spending for national defense and the entire Social Security program, along with veterans pensions and compensation. Of course, it also includes means-tested programs providing benefits only to low-income households, such as AFDC and Medicaid.

This leaves only $265 billion, or about 23 percent of the budget, for the achievement of tremendous spending cuts. Of this total, an estimated $174 billion is attributed to legally "cuttable" defense outlays, and according to a Congressional formula contained in the Graham-Rudman-Hollings bill, mandated cuts would be split 50-50 between the defense and non-defense areas of the budget. This could lead to huge defense cuts in FY 1987. Realistically, defense spending will probably be held down, but not slashed. If this occurs, then it is in the remaining areas of the budget totalling only about $90 billion, or less than 10 percent of the total, that Congress has any room to maneuver. Given the need to cut an estimated $60 billion in FY 1987 to reach the bill's target of a $144 billion deficit, it is easy to see that, unless defense spending is gutted, the Congress will virtually have to wipe out this area, including funds for education, training, transportation, science and research, and the environment.

While Graham-Rudman-Hollings protects the poor who are currently receiving public assistance -- mainly those low-income households where no one is working -- it spells the demise of any federal help for people who are not on welfare, but have relatively low incomes and are struggling to better themselves. The federal government will be forced, through the sheer arithmetic of this new mandate, to withdraw from two areas that are very important to today's young people: (1) the "front-end push" in the form of education and training that can help those who are not on welfare, but who are disadvantaged, get on a viable job ladder and stay off welfare; and (2) the investments in infrastructure, in the form of bridges, roads, and sewer systems, that will be needed in the future.

Of course, if the federal deficit were not reduced, young people would suffer in other ways -- they would have to pay enormous taxes in the future for today's profligacy. Therefore, we favor concrete actions to reduce deficits. But, in our view, certain groups with substantial political clout are not sharing in the sacrifice while others who are struggling to remain independent and self-sufficient, but who lack political power, will be cut off from assistance.

Some of the federal efforts likely to be eliminated have worked better than others, and some functions previously conducted federally could be performed locally or privately. The danger in the course we are now following is that the baby will be thrown out with the bathwater. Instead of a desirable reassessment of the proper role of the federal government, we will get a sudden exodus.

Left behind in this developing scenario are millions of working Americans with low and moderate incomes -- the working poor who are excluded from the safety net and households a little above the poverty line.

A similar scenario is unfolding on the tax side of the federal budget. Sensible, comprehensive tax reform proposals were initially presented (Bradley-Gephardt, Kemp-Kasten, and the initial proposal of the Reagan administration). The essence of these proposals was to earn lower tax rates by broadening the base. Subjecting more income to taxation not only would "finance" lower tax rates for households and business, but also would underwrite a large increase in personal exemptions, which would virtually end the payment of federal income taxes by the poor. The "average" taxpayer was to face a tradeoff -- lower rates, for which he or she would give up some deductions and exclusions from income.

Once again, government seems to be walking away from asking consumers to pay the price for benefits received. The tax legislation passed by the House of Representatives in December 1985 substantially abandons the essence of the tradeoff just described. Proposals that already started by preserving mortgage interest and property tax deductions in full, as a bow to political reality, were stripped of the other major possible sources of revenue affecting consumers that could finance rate cuts -- one by one, the deduction for charitable contributions, the deduction for state and local taxes, and the exclusion of employers contributions to employee benefits were preserved intact, leaving no real base broadening options affecting consumers directly. The result -- tax cuts for consumers paid for largely by cutbacks or eliminations of business tax incentives. Again, the consumer gets to "double his pleasure" and not take the pain. Of course, there will be pain. It will occur later if the changes in the treatment of such matters as the investment tax credit or depreciation lead to a decline in investment and a slowdown in the economy.

It is worth noting that the tax reform bill passed by the House retains the important virtue of ending the federal income tax liability of most poor households. In fact, this bill would help the poor more than some of the government expenditure programs with the same goal. The bill also has other favorable features. The point stressed here is that it reflects the government's continued hesitation to reduce the benefits that flow to relatively well-to-do households, whether those benefits are direct cash payments on the expenditure side of the federal ledger or tax preferences that show up on the revenue side of the budget.

This reflects the ambivalence of many Americans about government In an abstract and general sense, they believe that government is "too large." But, when it comes to a reduction in their benefit payments or their tax preferences, the fear of big government gives way to self-interest.

Assessing the Proper Role of the Federal Government

An effort to redivide or reorganize responsibilities for social programs requires a set of guiding principles or criteria. Simply shuffling programs around, or keeping some while killing others without clear criteria, makes little sense.

In devising these principles, it is useful to distinguish between meeting basic human needs and assuring people a chance to compete in the marketplace versus improving the local environment in which people live. We believe that there is a stronger case for the involvement of the national government in areas related to basic human survival and basic opportunities. The nature of problems such as hunger, malnutrition, and inadequate health care, as well as the need to obtain an education or protect civil rights, is more consistent or uniform across regions of the country than problems connected with mass transit, conservation and land management, or community development. The former set of problems is more amenable to standardized benefits and standardized human rights than the latter. (Standardized benefits and basic guarantees do not require standardized administration and implementation.)

The line between the provision of basic human needs and other important, but less crucial areas may, of course, become blurred. The distinction is not perfect, but it can be a useful starting point in the development of criteria for allocating responsibilities.

President Reagan deserves credit for providing strong impetus to the movement toward more decentralization of program authority within the public sector, as well as for highlighting the importance of private sector efforts to address social needs. A key problem with the Reagan administration's efforts to date, however, is the general lack of an overarching theme or a set of guiding principles providing criteria for program responsibility. The Reagan new federalism proposal in 1982 was vague, and it was launched in a framework of "swapping" or horse-trading that left some observers a little uncertain about what program responsibilities, if any, the administration felt fell within the purview of the federal government. The administration seemed to place the cart before the horse by offering various trades and negotiations prior to indicating what it believed was the underlying conceptual framework for distributing authority.

In program areas covering basic needs, we do not want as much "local option" or "privatization" as in other areas. Thus, we are uncomfortable with aspects of the administration's earlier proposals to swap one basic needs program for another or to include these programs eventually in a block with other, less pressing needs. At the same time, to consolidate and decentralize programs in areas such as energy, urban renewal, and community development makes sense.

The Reagan New Federalism program of a gradual phase-out of federal funding after an interim trust fund period would have ultimately put pressure on states and localities to raise their own revenues for social projects deemed worthwhile locally. For projects like downtown redevelopment, sports arenas, and water resource conservation, it may be desirable to encourage or pressure regions to become self-supportive. For nutrition, disease control, basic health insurance coverage, or minimal shelter, we are quite uncomfortable with a "local option" approach.

The Problem of Poor Targeting

Some people with little or no financial need are provided substantial government assistance in the U.S. while others with meager resources receive little or no government aid. These inequities can be found on both the expenditure and tax sides of the federal budget.

A major source of poor targeting on the spending side arises from the use of rather arbitrary categorical criteria for program eligibility. Instead of using indicators of true financial need as criteria for both eligibility for aid and the depth of federal assistance, the federal government uses an array of characteristics that define the status of citizens as member of large-scale groups that typically comprise both needy and non-needy members. For years, government aid has gone to the elderly on an undifferentiated basis, despite the wide variation in their financial situations. Other groups such as veterans, farmers, and the users of public transportation and waterways have received federal assistance, as a group, without targeting aid to to actual need.

Of course, there are rationales for such categorical criteria for distribution, and each group surely perceives that it deserves and needs federal aid. Clearly, veterans believe, with much justification, that they have "paid their dues" to society through active military service and deserve health care, housing finance, and other benefits in return. A similar argument is offered by military officials for a retirement plan that is quite costly and clearly far more generous than corresponding retirement benefits in the private sector. Farmers talk of being the "bread-basket" of the nation or indeed, of the world, and point to the dangers to the food supply from "unstable" markets for food products.

Moreover, in the cases of social insurance programs such as Social Security and Medicare, all beneficiaries, rich, middle-income and poor alike, have paid into the trust funds during their working years and can claim to "deserve" full benefits. And, all these programs are popular. People want them even as they rail against "big government." Americans are rather hypocritical and a little greedy about government. They want the benefits, but don't want to pay the costs.

Falling Into the Cracks

Categorical restrictions can also exclude certain groups whose needs are very real. For many years we have excluded large numbers of the poor from most federal assistance because they do not have the family status or other categorical characteristics for program eligibility. Thus, those deemed "independent" because they have intact families are denied aid if one spouse is working, no matter how low the wages are, and in about half of the states are even excluded from public assistance if the spouse is unemployed. Ironically, such families are, in effect, punished for their success in the labor market and in holding their families together, and penalized for their so-called independence. Such penalties, of course, may undermine the very independence upon which they are predicated.

A number of other "human capital development" and income maintenance programs were poorly targeted as President Reagan took office in 1981. For example, Federal assistance for student loans, by providing loans to all income groups at interest rates that were below market rates, resulted in some households without school-age children subsidizing other households with much higher incomes who had college-age children. The Reagan effort to target these subsidized loans more to lower and middle-income families made sense.

Education and training, however, offer excellent examples of areas where the federal effort needs to be re-shaped, and perhaps trimmed, but not eliminated. One can agree, for example, that the federal government threw an unnecessarily heavy regulatory blanket over education in the 1970s and that school authorities should have considerable autonomy and flexibility and still believe that the federal government has an important, though limited, role to play in education. Such programs as Pell grants that assist low-income students obtain a college education are a legitimate function of the federal government.

Another example of poorly-targeted federal aid involved the collection by unemployed manufacturing workers of Trade Adjustment Assistance while waiting to return to their former jobs and while simultaneously collecting unemployment insurance and company-paid unemployment funds. This program, originally designed to relocate permanently-displaced workers into more vibrant industries, actually piled another layer of income maintenance onto a federal-assistance pyramid that made the return to work unprofitable for workers in some industries. Such workers were collecting more after-tax dollars from their own version of the "safety net" than from their prior jobs, despite the fact that those jobs were among the best-paid positions in the manufacturing sector. Thus, in the late 1970s some of our highest-paid workers on temporary layoff were receiving tax-free, inflation-proof benefits, paid for by other workers who were, in some cases, more needy and more vulnerable to both inflation and taxes. Changes introduced by the Reagan administration in 1981 targeted these benefits more to need by synchronizing them with the exhaustion of Unemployment Insurance benefits.

Federal aid to cities raised still other equity problems. Through the federal "bail-out" of New York City, citizens of cities that had practiced more sober fiscal policies were being taxed, in effect, to rescue citizens of a profligate local government that had lived beyond its means and mortgaged its future for years. And, various federally funded downtown redevelopment projects, while often beneficial to the specific city where the work is done, involve transfers of tax dollars from one locale to another without any clear relationship to need or deprivation.

Of course, in all of these cases, recipients of federal spending could argue that there would be "externalities" or spillover benefits for the nation as a whole as a result of a rebuilt city or a bailed out company. The real issue involved questions about federal aid for people or locales that would seem to have the ability to help themselves (or were in trouble now because they didn't help themselves when they could have).

Some Recommendations

The following types of changes could lead to a more balanced approach to budget control than the one being followed at present.

1. All program areas would be "on the table" for budget-cutting. No sector of the federal budget would be exempt from review and change. This includes national defense and Social Security.

2. A greater portion of Social Security benefits could be subject to federal taxation. This could be accomplished through taxing a greater proportion of benefits above the current income thresholds than the present 50 percent rate, or by lowering these thresholds from their current levels of $25,000 for individuals and $32,000 for couples. Note that this is not means-testing. All eligible Social Security recipients would obtain their benefits, regardless of income, but more of the benefits would be subject to federal taxation.

3. A similar approach to Medicare would tax a proportion of the value of benefits. This could be the same proportion as in Social Security. Alternatively, Medicare could relate the Part B premium to income. In addition, Medicare could save money by adopting a more sensible way of paying doctors than the current "customary, prevailing, and reasonable" method. It could also achieve long-term savings through greater emphasis on disease prevention and health promotion, as well as benefit redesign to encourage care in noninstitutional settings.

4. The "double-exemption" for the elderly could be terminated or limited, as called for in the recent House tax reform bill. Other tax preferences benefiting primarily upper-income elderly households could be curtailed.

5. These types of changes in Social Security, Medicare, and tax preferences for the elderly would shield lower-income elderly people who are not likely to have much of a federal income tax liability. But, we could go further through such measures as raising SSI benefits to poverty line levels. The cost of helping the poor elderly would certainly not use up all the savings from the steps mentioned above, so that this package of changes would still shrink the deficit while redistributing benefits in the direction of need.

6. Civil service pension rules should be brought in line with prevailing private sector practices. Such options as full retirement at age 55 and annual COLAs are very unusual in private pensions.

7. The military retirement system should also be overhauled.

8. Programs for veterans should be targeted more clearly to financial need. This could be accomplished by steps outlined in President Reagan's FY 1986 budget proposal.

9. These program areas -- national defense, Social Security, Medicare, veterans programs, civil service and military retirement, together with interest on the national debt, compose about three-fourths of the federal budget. Sensible and fair cost control policies in these areas would go a long way to solving our budget problems while still meeting commitments to our neediest citizens.

10. Other areas of the budget, however, also deserve careful scrutiny and would benefit from new policy approaches. These areas include farm policy and Unemployment Insurance.

11. The basic safety net for the poor should be maintained and strengthened. Long-standing inequities in our public assistance program need to be addressed. This is the subject of the next section of this paper.

Reforming Health and Welfare Policy

No discussion of social welfare policy is complete without calling attention to the special problems that many economically disadvantaged groups experience in gaining access to health care services. Although the vast majority of Americans are well protected against the high costs of illness and can avail themselves of a medical care system second to none, for significant segments of our society access to health care is often woefully inadequate, and, in many cases, lacking entirely.

When it comes to health care, the poor frequently find themselves in triple jeopardy. They are twice as likely to be uninsured as the middle class and three times as likely as those in upper income groups (Davis & Rowland). Without financing, individuals use the health care system less frequently, even when they are ill. Yet the poor under-insured and uninsured are known to have generally worse health and a greater likelihood of low birth weight, hypertension, and other illnesses than higher income persons of comparable age.

The health of Americans -- particularly of the poor -- began to improve when Medicaid, Medicare, and certain more categorical health programs were enacted. Changes in federal policies and budget cut-backs in 1981, however, reversed some of the gains that had been made. The impact of cutbacks in AFDC and Medicaid fell most heavily on the poor and near-poor.

The question of access to health care for the poor is an issue relevant not only to social equity, but also to the social costs of dependency. While the relationship between ill health and poverty is not well understood, studies point to the potential influence of ill health on self-sufficiency and the ability to find and maintain a place in the labor market. As the welfare system becomes more job oriented, the value of extending adequate health care benefits and related services to target populations with fewer economic resources to overcome life problems (i.e. illness in the family) should be readily apparent. However, while the consequences of inadequate insurance coverage on the underserved poor has been well documented, an effective health safety net remains a promise yet to be fulfilled.

Matching Need to Benefits in Health Care

The organization and financing of federal health care programs, which comprise 22 percent of total social welfare spending, highlights the dilemmas that result from poor targeting and misguided matching of needs to benefits. The state and federally funded Medicaid program illuminates the problem most clearly. Although Medicaid is popularly perceived as a health care program for the poor, it covers only selected groups of low-income individuals and families who happen to meet its restrictive and confusing eligibility standards. Entitlement, linked to eligibility for welfare cash assistance under Aid to Families with Dependent Children (AFDC), is frequently more a function of where a person or family resides than of acknowledged need.

For example, monthly state payments for AFDC families of three with no countable income in January 1985, ranged from $96 in Mississippi to $719 in Alaska (Committee on Ways and Means, February 1985). In addition to income standards, low-income individuals must meet certain categorical requirements and be deemed "worthy" to receive benefits by virtue of family status, age or disability. Only those meeting specified income levels -- which in 23 states are below 55 percent of the federal poverty line -- and who are also aged, blind, disabled or part of a single-parent family with dependent children are categorically eligible for Medicaid.

Since its inception the Medicaid programs has in effect evolved into three distinct health care programs, each with a different recipient population. While the percentage of children living in poverty has risen sharply and the real value of federal assistance has declined, an increasingly larger proportion of Medicaid finances care for the elderly and disabled. To illustrate:

- Elderly persons, many of whom are forced to "spend down" to Medicaid eligibility in old age, account for less than 16 percent of all recipients, but more than 37 percent of all expenditures. These funds go primarily for nursing home care.
- The severely mentally retarded, the blind, and the physically disabled comprise 12.3 percent of all recipients, but use 30 percent of Medicaid outlays.
- Poor children comprised 43 percent of all Medicaid recipients, but received only 13 percent of the program's dollars.

Medicare provides basic coverage for most medical care for persons 65 years of age and over, regardless of income. Yet the program pays for only about 45 percent of the total health care outlays of the elderly. A substantial portion of the remaining 55 percent is accounted for by beneficiary copayments for covered Medicare services, but a very large share of the "gap" involves services such as long-term, chronic, and preventive care that are, with some very limited exceptions, not covered by Medicare. The first-day deductible for hospital care (Part A) rose 23 percent last year, from $400 to $492. While 66 percent of the elderly purchase private insurance to supplement their Medicare benefits (Cafferata, 1984), it has been found that this type of extra protection is more prevalent for some groups than for others. A recent analysis by the National Center for Health Services Research (NCHSR) shows that overall, one-fifth of elderly Medicare enrollees lacked both private and public supplements to Medicare; this proportion rose to one-quarter among persons 75 years and older, among those with poverty or other low incomes, and among those in only fair and poor health (Cafferets, 1984).

Meeting the health services requirements of a rapidly aging population at a time of severe budget constraints has put into question the undifferentiated benefit structure that characterizes Medicare. Given that, as a group, America's elderly are at least as well off financially as the population as a whole, the program's flat benefit schedule tends to overcompensate some and undercompensate others relative to actual need.

Some of the inequities and ill-conceived matching of benefits to needs are reflected as well in private work-based insurance coverage.

Most large employers are able to offer their employees high style and low cost health care benefits, heavily subsidized by the special tax advantages granted approved employee benefit offerings. Yet, over 50 percent of the workforce is employed by small employers, organizations of less than 25 workers. For insurers, these groups represent high cost and unstable risk pools. As a consequence, small employers find it much more difficult to provide adequate, affordable coverage for their workers. It is small employers, however, that tend to hire a larger proportion of low-income, minority, and/or part-time workers: individuals who lack the financial resources to purchase needed coverage on their own.

Identifying the Populations Most at Risk

At this time of restricted funding, changing federal policies, and inexorable pressure for deficit reduction, there appears to be growing interest in better targeting of benefits to those most in need. In health care, as well as in other areas of social policy, activities are underway at both federal and state levels, geared at reviewing existing financing programs to determine the types of benefit redesign that could use increasingly limited resources more cost effectively, and enable some extension of coverage to those underserved who now fall through the cracks.

To address this challenge in a constructive manner, there is value in looking behind overall numbers and trends. Aggregate statistics often camouflage components which may be even more important than the trend itself for designing effective public policy. For example, numerous studies and surveys now indicate that the elderly, once a relatively low-income group, are now actually quite well-off. Fifteen years ago, one-quarter of the aged lived in poverty -- twice the rate of the general population. Today the poverty rate for the elderly has been halved; at 12.4 percent in 1984, it was lower for them than the 14.4 percent for Americans overall (Report of the President's Council of Economic Advisers, 1984).

Before one stereotype is replaced with a new one, however, it is essential to look behind the statistics -- the aggregates mask the disparate circumstances of the nation's elderly. Despite rising prosperity among the elderly as a group, the Economic Report of the President notes that some elderly individuals remain very poor, most frequently elderly women who live alone, elderly blacks, and people over age 75. Twenty percent of women over 85 live below the poverty line; for black women in this age category, the percentage rises to 46.6. Poverty remains pervasive among the 6.2 million older Americans who rely on Social Security for 90 percent or more of their income.

What becomes clear is that the over-65 population has become too broad a category for monolithic government policymaking. An argument might be made for modifying Medicare health insurance benefits and Social Security retirement payments for the well-off elderly. At the same time, some additional government assistance may go a long way to help those low-income "older-old," a cohort that has run out of economic and physical well-being, and who have legitimate unmet needs for health services and living assistance. Furthermore, the desirability of some level of tradeoff in Medicare -- expanded protection against the catastrophic costs of long-term illness in exchange for diminished front-end coverage -- deserves more thorough discussion.

The importance of looking behind aggregate numbers becomes apparent as well in discussing today's most vulnerable target population -- poor children. Last year's U.S. Census Bureau report showed nearly a full percentage point decline of Americans living in poverty -- after five years of steady increases. A trend within that trend, however, deserves at least as much attention. Of all Americans living in poverty today, 40 percent are under the age of 18. Indeed, poverty among the young has more than doubled in the last five years; yet, the major forms of federal aid to children (education, AFDC, health programs, food stamps, child nutrition programs) were significantly cut in real terms.

Although the cost-effectiveness of extending basic health services to children has been amply proven (Select Committee on Children, Youth, and Family, 1985), many children are screened out of Medicaid and denied a regular source of health care. Poor children are one-and-a-half times more likely than nonpoor children not to visit a physician at all during a year. By neglecting primary and preventive health services, these restrictions lead to poor health and large outlays down the road for acute care.

A recent DHHS study of minority health problems indicated that there may be as many as 60,000 "excess" deaths each year among black Americans. The report identified poverty, lack of health insurance, and poor prenatal care as major contributors to health problems. The report underscored one of those key trends within trends: although infant mortality in this country has declined in recent years, black infant mortality rates continue to be double those for whites.

Current interest in targeted interventions rather than aggregate solutions has prompted many states to expand their Medicaid programs to extend basic health care services to poor children and mothers who either were previously ineligible or cut from the rolls as a result of OBRA. For example, new and relaxed legal requirements, mandated by P.L. 97-35, gave states the option of implementing Medically Needy programs that extend prenatal and delivery services to indigent pregnant women and ambulatory care to children without extending case assistance and without providing a full-scale medically needy entitlement to the aged and disabled, who account for by far the greatest proportion of a state's overall Medicaid budget.

The potential for covering additional numbers of poor through this type of Medicaid expansion has, in reality, been somewhat limited. By implementing a Medically Needy program and extending Medicaid to select individuals with incomes up to 133 percent of the AFDC payment standard -- states have the option of setting it lower -- a state may simply be restoring benefits to people who have lost coverage, not because they have become less poor, but because AFDC payment limits have not kept up with inflation.

The Deficit Reduction Act of 1984 (P.L. 98-369) reversed some of the funding cutbacks that had come with the passage of OBRA. The act enabled certain families, who have lost or who might lose AFDC because of limitations on earned income disregards, to maintain eligibility for Medicaid for at least nine months (and at state option, for an additional six months). P.L. 98-369 established a modified child health assurance program (CHAP) that requires states to extend Medicaid coverage to the following groups meeting the AFDC income and resource criteria: first-time pregnant women, married pregnant women in two-parent families and children under five years of age. The fiscal 1986 budget reconciliation bill, which failed to pass the Congress before the 1985 holiday recess, would require states to provide prenatal and postpartum care to pregnant women in two-parent families that meet AFDC income and resource standards even if the principal wage earner is employed.

Despite the breadth and costliness of public and private programs -- total outlays for health will approach $400 billion this year -- more than 1 in 10 Americans remain without health insurance (Robert Wood Johnson). Not all of the uncovered are poor; many of them are young and in good health, while half of them are employed. Major concern has focused on the uninsured poor. Studies show that these individuals are almost 2.5 times likely as nonpoor individuals to be in fair or poor health (RWJ). These days, however, increasing attention is also being focused on broadening the coverage available through the workplace, especially for the working poor, the temporarily unemployed, and dependents who become widowed or divorced.

Debate continues at the national level about the nature and scope of the indigent-care problem, the kinds and numbers of people who are most in need, the extent of the burden on health care institutions and the appropriate steps to ameliorate this dilemma. In the absence of federal leadership, states are fashioning their own responses. In 1985, 30 states considered legislative proposals that either mandated improvements in state or county indigent care programs, or required the establishment of a commission to examine the issue (IHPP, 1985).

Several points are worthy of mention in assessing the numerous efforts now underway across the country that attempt to fill the gaps in health care coverage for the underserved. While many states are opting for selecting expansion of their Medicaid programs and/or other financing mechanisms, equal emphasis is being placed on assuring that available resources are used more cost effectively. A growing number of states are enrolling their Medicaid population in prepaid delivery settings or primary care networks where providers are given incentives to deliver care in the most appropriate and efficient manner. Improved integration of services and outreach programs are being implemented in Texas and other states to extend more comprehensive and more easily available coverage to poor pregnant women and children. In states like New York, Florida, and South Carolina, indigent care pools have been established that attempt to redistribute dollars among hospitals -- shifting funds from well-off institutions that provide little charity care to those that serve disproportionately larger numbers of poor and underserved. This approach helps to offset the competitive advantage hospitals might otherwise gain by reducing the provision of services to charity care patients. A number of other states are considering "care or share" types of initiatives.

While state that have taken a leadership role in addressing the problem of medical indigency should be commended, the federal government's desire to devolve this social welfare responsibility almost entirely to the states is in our view both inappropriate and inequitable. The wide variation among states in per capita income, economic conditions, resources, and underlying commitment to serve the disadvantaged calls for a more positive agenda on the part of the federal government.

Today, the specter of Gramm-Rudman-Hollings threatens our patchwork safety net. Although AFDC and Medicaid are ostensibly "protected" (for how long, we wonder), important programs like the Maternal and Child Health Block Grant stand to be cut be as much as 50 percent. MCH provides funds to states to promote, develop, and deliver a range of health services to impoverished and medically underserved mothers and children. In many states MCH dollars are used to supplement absurdly low Medicaid payments to providers, often assuring that providers of care are available at all to serve this target population. Gramm-Rudman-Hollings throws a dark shadow on many other programs that serve the disadvantaged poor.

Clearly there are no easy answers, no silver bullets in the search for effective and affordable social welfare policies for the 1980s and beyond. Welfare, even if properly conceived, cannot by itself solve problems ranging from teen-age pregnancy and poor infant nutrition to bad schools and inadequate values. There is a need to set realistic goals, however, rather than retreat from the whole problem. A few recommendations follow:

1. In this era of severe budget restriction and widespread unmet needs, it is important to disaggregate trends to identify populations at highest risk. Women receiving AFDC, teen mothers, teenagers who are dropouts and/or unemployed, minorities (especially young unemployed black and hispanics) and the poor "old-old" have particular needs that must be addressed.

2. Continue efforts to create a universal prenatal and infant care financing system in which every needy pregnant woman

and infant regardless of categorical eligibility for AFDC is assured of receiving care. By enfranchising pregnant women and children, the government extends benefits to a group whose medical care requirements are fairly predictable and among the least costly of all potentially Medicaid-eligible populations.

3. Too much emphasis has been placed in the past on the benefit structures of federal assistance programs. More attention should be given to outcomes and how programs actually work.

4. A case can be made for the long-term cost effectiveness in providing "extra" benefits (e.g. child care, health insurance coverage, food stamps, etc.) for those struggling to be self-sufficient. There is a need to provide individuals and families with few economic resources the kind of support that will get them over "rough spots."

5. In the continuing debate over federalism, we argue strongly that the federal government should set minimum payment standards under the AFDC program. This would smooth out some of the inequities in welfare and also enable more people with very low incomes to receive Medicaid. States could still supplement benefits above the federal floor, and would take the lead in administering AFDC and Medicaid..

6. State and local governments should take more responsibility for public sector efforts for economic and community development (e.g. highways, housing, mass transit, etc.)

Mr. **McNamee**. Thank you, Mr. Meyer. Your point is well taken. During a previous panel I was thinking about a fact that we might consider here. Dependency programs like AFDC and Medicaid are the programs that are exempted from Gramm-Rudman whereas many of the opportunity programs will be falling under the ax.

To remind you, don't be hesitant to get your questions up here so that we can answer them. Staff members will bring you a card and bring the question up. Just hold up your hand.

Our final panelist is Mary Jo Bane. She's the executive deputy commissioner of the New York State Department of Social Services, where they have been working on many innovative programs along the lines of what we're talking about, and she is on leave from the John F. Kennedy School of Political Science and Government at Harvard University.

PRESENTATION OF MARY JO BANE

Ms. **Bane**. Thank you. I've been curious about what happens after the red light has been on for a while, whether it's swords or—I suppose I'm not going to take a chance.

Mr. **McNamee**. I've been told that no one so far has had to pull the lever. I hope I'm not the first.

Ms. **Bane**. Good. I'd like to direct our attention, following up on some of the things that other people have said, to the fact that it is women and children, particularly female-headed families with children, that today make up the vast bulk of our welfare caseload. That's true, of course, in AFDC but it's also true of food stamps which is the other main income-tested program.

It seems important, therefore, that we look at some of the relationships among family structure, poverty, welfare and possible policy changes in the welfare system.

Many of the facts are well known and I suspect have been talked about in other panels. The first has to do with poverty rates among children, most poignantly among black children. The poverty statistics for 1984 showed a poverty rate among children of 21 percent and among black children of 46 percent. A growing proportion of children is growing up poor and the situation is getting worse.

In 1970, the poverty rate among children was 15 percent, 6 percentage points lower than it is today.

The second fact that I suppose we all know has to do with changing family structures. Again, focusing on children, in 1984, 25 percent of all children and 59 percent of black children were living in a family situation other than with both their parents. Most of them were living with their mothers, some in three-generational families, some with their grandmothers, some in other kinds of situations.

In 1970, in contrast, only 15 percent of all children—and that seemed like a very big number in 1970—and 40 percent of black children were living in family situations other than with both parents.

Now both of these trends represent grounds for extreme concern and, of course, they are connected. As we all know, one-parent families are much more likely to be poor than two-parent families. In 1984, among white children living in two-parent families, 11 percent were poor; in single-parent, female-headed families, 46 percent were poor. Among black children who lived in two-parent families, 24 percent were poor; among black children in single-parent families, a startling and shocking 66 percent were poor.

Now people sometimes seem to conclude from these dramatic numbers that the poverty problem could be solved if only ways could be found to encourage more stable marriages and to deter births of unmarried mothers.

The facts, however, are a little more complicated than that. Some analyses I did of both census and longitudinal data suggests two patterns, a little bit akin to the hardcore and the temporary that another of our panel members mentioned. But these I think are found among single-parent families as well as distinguished the elderly and disabled poor from the other kinds of poor.

One pattern which I found more commonly among female-headed families was what you might call an event-caused poverty where the familiy was not poor before the family broke up but the women and children became poor afterwards.

A second pattern—and this was more commonly found among black female-headed families—was what I have called reshuffled poverty where an already poor family broke up or where the daughter of a poor family established her own poor household.

These findings reinforce I think other analyses having to do with the duration of poverty and welfare and they suggest that the feminization of poverty, like poverty in general, is really two different problems; one of usually temporary poverty for women whose poverty follows from the family change and often disappears after a few years, and one of chronic poverty for women whose situations offer opportunities for neither men or women.

The current welfare system has not dealth particularly well with either problem, though I might disagree with some of the panelists and say that not only does the current welfare system fund my job—which I suppose make the rest of this sound a bit self-serving—but in terms of temporary poverty for people who are trying to get through a difficult situation and recover from the effect of a divorce or breakup, pure income transfers are not such a terrible thing.

But basically, I think we can all agree that the welfare system has not been wonderful and I don't make this judgment because I believe that welfare has made a major contribution to family disintegration. I don't in fact believe that. Without getting too deeply into that debate, which has generated enormous controversy over the last year or so, let me just say that some research that David Elwood of Harvard University and I did on the relationship of AFDC benefit levels to family structure changes showed that there's really a very small effect of benefit levels on the divorce and separation rates, no discernible effect on birth rates to unmarried men.

Nonetheless, welfare doesn't serve either the temporarily poor nor the chronically poor very well. For the temporarily poor, two changes could prove important. The first has to do with benefit levels which in no State I believe are high enough to keep a family with no other income out of poverty.

The decline in real benefit levels since the mid-1970's has been striking and has been an important contributor to poverty among female-headed families. I have found nothing in my research to suggest that raising welfare benefit levels would make things worse, much to suggest that it would make them better.

A second set of desirable changes would address the fact that it is currently quite difficult to make the transition from welfare to other sources of income. Once on AFDC, a client finds almost no incentives—and this has been mentioned before—or expectations for working or for obtaining child support, which is another important part of this equation. Benefit levels are reduced almost dollar for dollar of other income. There are no work requirements, few work opportunities for AFDC recipients who have children under six. In most States going off AFDC also means losing Medicaid and the opportunity for health care for your children.

Now these characteristics of AFDC, that benefit levels are low and that it's hard to get off, make it inappropriate as a temporary income support program. There are some changes that can address that.

Recent Federal legislation toughens child support obligations and provides incentives for meeting them. States are moving toward employment and training programs—and I'll talk about this a little more later—for women with children.

A farther-reaching approach is a guaranteed child support system. This approach, advocated by analysts at the University of Wisconsin—the chairman of this committee comes from a State with many innovations—is analogous to the guaranteed maintenance system in European countries and would combine automatic wage withholding for child support payments with a State-guaranteed mimimum.

I think this is an idea that the details have not been worked out but it's an idea which deserves serious consideration.

Now programs, though, to increase child support and to provide job search programs and so on to raise benefit levels in some ways speak to the easy problem. The harder problem, that of chronic poverty, remains.

Now the welfare system can't be the whole solution to that problem. It can, though, I believe, contribute. As many people have said, the key to that harder problem is jobs, self-sufficiency for men and women, so that the men can pay the child support, so that the women can support themselves and contribute to the support of their families as well. For that, we need all things that people have been telling us about—general economic development, stimulus for the development of job-intensive industries, and so on.

With regard to the welfare program, there's another side of this—education, job training, employment readiness, work experience programs—are all important parts of the other side. These training and employment readiness opportunities can be offered through the welfare system. Many States, including New York I'm proud to say, are moving towards it and are finding it appropriate to require welfare recipients to participate in some combination of them.

Chronic poverty has not gone away and it's not going to. However, many of us would like to pretend that it doesn't exist. It's not going to be solved by pandering about the decline of the family or by exhortations to young men and women to behave better, though we might try that, too.

We can, I think, make some improvements in the welfare system to place more emphasis on work, on child support, on family responsibility. But the problem is a very deep one and it's going to require a lot of work. We can't afford to misunderstand it or ignore it. Thank you.

[The complete presentation of Ms. Bane follows:]

FAMILY STRUCTURE, POVERTY AND WELFARE

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Presentation for panel on "Moving from Welfare & Dependency to Work & Opportunity", Symposium on the American Economy in Transition, sponsored by the Joint Economic Committee, Washington, D.C., January 16-17, 1986.

The general topic of our panel this morning, "Moving from welfare and dependency to work and opportunity," inevitably directs our attention to the female headed families with children that make up the vast majority of the welfare caseload. I would therefore like to focus my remarks on the relationships among family structure, poverty, welfare, and possible policy changes in the welfare system.

Many of the facts are well known. The first has to do with poverty rates among children, most poignantly among black children. The poverty statistics for 1984 showed a poverty rate among children of 21 percent and among black children of 46 percent. A large and growing proportion -- almost one of every two black children in this country -- is growing up in poverty, and the situation is becoming worse, not better. In 1970, the poverty rate among children was 15 percent, or about 6 percentage points lower than it is today.

A second fact has to do with changing family structures. Again focusing on children, in 1984 25 percent of all children and 59 percent of black children were living in a family situation other than with both parents: most with their mothers, some in three generational families with their mothers and grandparents and a few in other kinds of situations. In 1970, in contrast, 15 percent of all children and 40 percent of black children were living in family situations other than with both their parents.

Both of these trends represent grounds for extreme concern. And they are connected. As we all know, one-parent families are much more likely to be poor than two-parent families. For example, in 1984, of white children living in two parent families about 11 percent were poor, while 46 percent of those in female headed families were poor. Among black children who lived in two parent families, about 24 percent were poor. Among black children who lived in single-parent families, a startling 66 percent were poor.

People sometimes seem to conclude from these dramatic numbers that the poverty problem could be solved if only ways could be found to encourage more stable marriages and to deter births to unmarried mothers. The facts, however, are a little more complicated than that. Some analyses that I did of both census and longitudinal data suggest two patterns. One, found more commonly among whites, was of what we might call "event-caused" poverty, where the family was not poor before the breakup but the woman and children became poor afterward. A second pattern, more common among blacks, was what I have called "reshuffled" poverty, where an already poor family broke up or where the daughter of a poor family established her own poor household.

These findings reinforce, I believe, other analyses of the duration of poverty and welfare use, and suggest that the "feminization of poverty" is in reality two different problems: one of usually temporary poverty for women whose poverty follows directly from a family change; and one of chronic poverty for women from situations that offer opportunities for neither men nor women.

The current welfare system has not dealt particularly well with either problem. I do not make this judgment because I believe that welfare has made a major contribution to family disintegration among poor families; I do not believe it has. Without getting too deeply into that debate, let me just say that the research that David Ellwood of Harvard University and I did on the relationship of AFDC-benefit levels to family-structure changes showed that while welfare-benefit levels had significant effects on young women's decisions to live independently rather than with their parents, they had small effects on divorce and separation rates, and no discernible effects on birth rates to unmarried women.

Nonetheless welfare does not serve either the temporarily poor nor the chronically poor very well. For the temporarily poor, two changes could prove important. The first has to do with benefit levels, which in no state are high enough to keep a family with no other income out of poverty. The decline in real benefits levels since the mid-1970s has been an important contributor to poverty among female-headed families, and to their increasing poverty rates since 1979. I have found nothing in my research that would suggest that raising welfare- benefit levels would do anything to make things worse, and much to suggest that raising them would make things better.

A second set of desirable changes would address the fact that it is currently quite difficult to make the transition from welfare to other sources of income. Once on AFDC, a client finds almost no incentives or expectations for working or obtaining child support. Benefit levels are reduced almost dollar for dollar of other income. There are no work requirements--not even job search or employment registraion--for the vast majority of AFDC recipients who have children under 6. In most states, going off AFDC also means losing Medicaid coverage either immediately or very shortly thereafter.

These characteristics of AFDC that make it inappropriate as a temporary income support problem have often been identified as problems. And at least some of them appear to be solvable. Recent federal legislation not only toughens child support obligations but also provides incentives for meeting them. States are moving towards employment and training programs for women with younger as well as older children.

A farther reaching approach is a guaranteed child support system. This approach, advocated by analysts at the University of Wisconsin and analogous to the guaranteed maintenance systems of several European countries, would combine automatic wage withholding for child support payments with a state guaranteed minimum payment to the non-custodial parent. The benefit would not be means tested, and would be sufficient when combined with part time work to bring the family to or above the poverty line. The structure of the program provides powerful incentives for both work and child support, and thus places governmental programs in their proper role as supportive of parental responsibility.

Unfortunately, the proposals described above speak to the easy problem. The hard problem, that of chronic poverty, remains. The welfare system, of course, cannot be the whole solution to the problem of chronic poverty, though it can, I believe, contribute. The key to a more lasting approach is jobs. Self-sufficiency for men, women and families requires that they have jobs, which in turn requires that jobs are available and that men and women have the skills and motivations to hold them. General economic development, stimulus for the development of specific job intensive industries, and careful management of public sector employment are all parts of this solution. Education, job training, and employment readiness programs for potential workers are other parts. These training and employment readiness opportunities can be offered through the welfare system, and more and more states are finding it appropriate to require welfare recipients to participate in them.

Experience with employment programs over the last two decades has not been uniformly positive. None of the "solutions" that have been tried since 1960 seems to be especially powerful. But it is hard to see any dramatically new approach on the horizon that would be likely to be any more effective. Both the demand side and the supply side of the labor market would seem to require some sort of public intervention. Continued experimentation with programs of various sorts seems to be the only way to go.

Chronic poverty is not going to go away, however many of us continue to pretend that it does not exist. Nor will it be solved by hand-wringing about the decline of the family or exhortations to young men and women to behave better. We can make some improvements in the welfare system to place more emphasis on work and family responsibility. But poverty is deeply rooted and seems to be getting worse in some segments of our society. We cannot afford to misunderstand it, or to ignore it.

Mr. **McNamee**. Thank you. I'd remind our audience that we've got quite a good collection of questions up here but we're still in the market for more.

The point that many of the panelists have made is the necessity of targeting and separating the different constituencies of the programs to get the most bang for the buck. One of the questions points out that many of these Government programs start out with a focus on the genuinely disadvantaged and then, as if by magic, they get a middle class constituency and a permanent lifespan, plus higher and higher costs.

I guess there are two questions there. One is, is there any way to keep this from happening; and the flip side of that question is, if it doesn't happen, do these programs then become vulnerable in a budget-cutting era? In other words, the middle class constituency, you can't live with it and you can't live without it. Does anyone want to tackle that one?

Mr. **Meyer**. Well, I'd just like to start by saying that I challenge the premise of the question. I don't think most of the low-income programs are poorly targeted or reach up into the middle class. Look at a program like food stamps. Congress lowered the cutoff line from 145 percent of poverty to 130 percent. That doesn't reach up too far into the middle class.

If you look at AFDC and Medicaid, two other major programs, they are tied to the AFDC cutoff lines. That's 185 percent of State need standards. I gave you a picture of where most of those State needs standards are. They are well below the poverty line. Some of them are a fraction of the poverty line, so that after you multiply them by 185 percent you have need standards that are below the poverty line in many States or slightly above it.

I think the real problem is that when you look at our entire social welfare complex as a whole, it is not well targeted. Therefore, the challenge is not to take the poverty programs as a group and say here are all the problems with them. There are some, but this leaves aside the many other social programs. Veterans programs aren't well targeted to need. There have been some proposals before the Congress including those of the Reagan administration that would ask a little more and put some deductibles and cost sharing into certain veterans programs—very controversial politically to do, understandably. Cases can be made in each instance not to target benefits more tightly.

But I think we really have to look at it in that way, and I certainly don't find the poverty programs a giveaway. We do need to look at their effect on work incentives, but we also should examine the effect of other programs on work incentives as well.

Mr. **McNamee**. Professor Gwartney.

Mr. **Gwartney**. I'd just like to make this comment on the question. First of all, I think it's a very good question because it explains what tends to happen under the current system. You have roughly 75 to 80 percent of the total transfers, counting unemployment compensation, Social Security, the farm program, in addition to means-tested programs, that go to individuals well above the poverty line. You have political vote trading and things of that sort taking place within this process. There's no reason to think that the poor are going to be particularly powerful within the framework of this decisionmaking process.

Now one of the things I think we should give some serious consideration to is establishing property rights, particularly for retirement programs, where the individuals would have tradable property rights. This would take them out of the realm of essentially income transfers. Individuals would be able to pass the property rights—for example, a Government bond or mayble a kind of modified IRA scheme or something of that sort on to their heirs.

It's interesting, speaking of Social Security that it does have some very negative side effects upon helping person of low-income status. One of those is that because of the fact that the life expectancy of blacks is lower than whites, the years during which blacks will draw Social Security will be fewer than for whites. Therefore, the rate of return that blacks get on Social Security is less than whites.

While the data are not quite so clear-cut with regard to the poor, I expect that in general this is also true for the poor. The life expectancy, for example, of the average blue collar or low-income workers is probably less than the average white collar high-income worker and, therefore, they also draw fewer years of Social Security.

So one of the things that I would favor taking a hard look is attempting to establish an actual property right for the recipient and thereby take non-equalitarian transfers out of this realm of the political football.

Mr. McNamee. I think Bob was next.

Mr. Kuttner. I think the one thing you can be sure of with regard to means tested programs is that they are going to be badly funded, they're going to be degrading, they are not going to be as good as programs that are for everybody. Take our oldest and most expensive social program, free public education. I suspect that if that hadn't been invented 200 and some odd years ago and it was being proposed from scratch in 1986, that the Reagan administration would probably oppose it and that they would propose making it means tested if you had it at all.

But if you stop and think what public schools would look like if nonpoor people had to pay tuition or if they were restricted to the socalled truly needy, you begin to appreciate why social programs inherently have to be universalistic programs in order to work.

Now that doesn't mean you can't have degrees of needs testing. For example, I think paying tax on your Social Security checks or on a portion of them the same way pension funds are taxable is a good idea. It introduces a degree of needs testing into the program without making it a program just for the poor.

The other striking example is the difference between Medicare and Medicaid. Medicare is a middle class program. It has been defended against inflation better than Medicaid, but the fact that we have this two-track or three-track health care system in the United States is the reason why we pay a larger percentage of our total income nationally for health and get less than any other advanced country.

So I think, yes, you're damned if you have the middle class and you're damned if you don't. But you cannot have decent social programs that have broad public support without having them be universal progams and even within that reality there are ways of limiting costs. There are ways of saving on waste.

But we kid ourselves if we think that the social overhead of a modern society can be done either cheap or it can be done by targeting benefits to the so-called truly needy.

Mr. **McNamee**. Ms. Bane.

Ms. **Bane**. One of the criticisms that has been made of work programs and training programs and so on is that they tend to engage in creaming, picking the best folks to send off for the training and, lo and behold, they do well, just as they would have anyway.

But one of the most disturbing research findings I have seen a report on recently, if true—and I haven't actually read the research itself—has to do with a program in which people were given job subsidies that they could present to an employer and say, "Hi, here I am. It's going to be cheap to hire me because I've got this nifty subsidy from the Government." And the finding is that at least in some cases the people who have those subsidies did worse than the people who didn't because holding that subsidy in your hand identified you as a loser for sure and led to reluctance of employers even under subsidized conditions to hire them.

I think that illustrates the dilemma probably as well as anything one can say and, as an administrator, one is led to the belief that maybe creaming isn't so bad, that the first people I'm going to send over to those employers will indeed be folks that I hope will succeed so that we can build up confidence and so on. But it is a genuine dilemma I think.

Mr. **McNamee**. Chairman Obey wanted to comment.

Chairman **Obey**. I just wanted to make a rare comment during one of the panels because I think what we're talking about here really identifies the toughest dilemma that we face in this area and it is true, you're damned if you do and damned if you don't.

I agree in terms of equity and in terms of what you ought to be able to do in a society which was run like heaven, what you ought to be able to do is means test a lot of these programs. The problem is when you do you get whipsawed politically.

Example: I remember a number of years ago we were losing support for student aid programs in this country because they were seen, with the exception of a couple of them, of being focused primarily on the needs of the poor. So I would get people coming up to me every time I was out in public:

> Why in hell do I have to pay to support student loan programs or student grant programs? We're not making a lot of bucks and yet my kids can't participate. It only goes to somebody who's poor enough or if you're on the high of the income scale then you've got it made and you don't have to worry.

So Bill Ford and I and a number of others, Jim, tried to push the middle income student assistance act. We did. It passed. Political times changed. In about 3 years we had people chewing on us suggesting that we ought to cut the guts out of student aid programs because family "x" that made income so much above the poverty level was getting this dough and they didn't need it. I mean, that's the dilemma we face and what I have never been able to figure out how to do is to means test these programs and gain the support in doing so for the very groups in society who do the most squawking when we don't.

Mr. McNamee. Mr. McEntee.

Mr. McEntee. I just wanted to make one comment because we always do hear this about taking that domestic side of the budget and those kinds of programs and targeting need and we hear that argument and it's an argument all across the country. I would only hope—and I don't have an immediate answer to that, but somebody said earlier, what's good for the goose is good for the gander. I would only wish they would hold the Defense Department budget up to the same kind of standard in terms of targets of need and then maybe we would be able to get some of those dollars and bucks that Secretary of Defense "Cap" Weinburger has over on the side of the budget.

Mr. McNamee. Well, if things keep going like this I can ask two more questions and be out of here.

We have a lot of questions about workfare and its relationship to these programs. First of all, I noticed that New York was one of the States listed on Mr. McEntee's list. I wanted to ask Ms. Bane what her viewpoint on workfare is and whether she feels it is degrading for the recipient and for the people who have to work alongside them.

Ms. Bane. This is certainly a controversial subject and I guess I want to say two things about it. In the program that we are putting together and that Governor Cuomo has been talking about recently we are not calling it a workfare program. We are calling it a work-not-welfare program, and are designing it in such a way that opportunities to obtain training, to participate in educational experiences, to gain skills and so on are as important a part of the program as anything else.

We also believe, though, that work experience can be an important part of developing skills and developing moving into the work force and so we do not preclude work experience as something that our clients can participate in. That will sometimes mean working in public service agencies. Indeed, that's one of the main places where work experiences are provided and created.

We will try—and I know other States are trying too—to make sure that the work experience is one which provides genuine opportunities, genuine training. We will provide to the best of our ability in the statute that we draft protections for the workers who might potentially be displaced. We are not, of course, insensitive to the needs and desires of workers.

We do feel, though, that work experince can be an important part of employment opportunities programs and I don't want to leave that out.

Mr. McNamee. Mr. McEntee.

Mr. McEntee. Well, we would agree with the fact that Governor Cuomo in his recent budget presentation that the program that he is talking about, as compared to the program that had been going on in New York City and New York State, is a genuine improvement. It's adopted any number of the points now in the Massachusetts program which we see as a real decent kind of program.

Our experience with the programs that had been existing in New York City, for example—I can give you one example where we had individuals that had been laid off working in the parks. They received their unemployment compensation for a limited period of time and then eventually found themselves on welfare and then eventually found themselves on workfare and ending up in the same job in the park that they had been laid off from. Well, if that's not degrading I don't know what the hell it is—degrading to that person, degrading to other people that work in the same kinds of classifications.

For it to work—and you can look at all the statistics and all the facts—for it to work, if we want it to work, it has to have the educational component; it has to have the health component. As we say, most of these people or an awful lot of these people on welfare are women. A child care component must be involved in this as it is involved in Massachusetts and we would like to see all of the States look at the Massachusetts program as an ideal, as a pilot program, and the statistics have shown that it works.

It's going to be awful hard for that one to work now with Gramm-Rudman because Massachusetts has been able to use WIN money and job training money to put together what in fact has been an effective program, but I don't know what they're going to do if Mr. Gramm and Mr. Rudman are still riding in the saddle months from now.

Mr. **McNamee**. Professor Gwartney first and, Bob, we've got a special question for you on this subject.

Mr. **Gwartney**. Two quick points on this topic. One of the most harmful side effects of the current programs, particularly the programs that were in effect throughout the 1970's, is that they tend to result in non-labor force participation. During that period of time, skills depreciate. If persons are out of the work force for 2, 3, 4 or 5 years, it's increasingly difficult for them to enter into the work force and compete.

In the terminology I used previously, essentially the programs transform an individual with the passage of time, from a marginally poor person to a hardcore poor person as a result of skill deterioration.

The second point I would make is, as I'm sure most of this audience is aware of, there are a number of States experimenting with different kinds of workfare programs and, from my way of thinking, this is precisely the right pattern that should emerge. There are a lot of things we don't know about how these programs work now—what's going to be effective and what's not going to be effective.

By New York trying one thing and Massachusetts trying another and San Diego trying a third and other States a fourth and fifth and so on, we're going to learn some things through this experimentation. The successful programs will tend to be copied. I think this experimentation at the State and local level is a very healthy thing.

Mr. **McNamee**. Representative Scheuer.

Representative **Scheuer**. One of the problems with the poverty program was that we treated our successes the way we treated our failures and we treated our failures the way we treated our successes and we never really did scrutinize the whole length and breadth of those poverty programs to see which worked, which didn't work, and what were the elements that seemed to predict success and what were the elements that seemed to predict failure, and then recast the programs that could use a little recasting to perfect them and cut out the programs that didn't.

I agree with you it's a good think that there's a lot of experimentation going on and it's a good thing that there's some ferment going on, but I would like to see where is the scrutiny, the objective scientific scrutiny of these programs against a set of common criteria to evaluate why they are not working or why they are working and try and replicate the conditions that seem to produce success and to either cut out the elements or components that produce failure or wipe out the programs that seem fatally flawed.

When Sarge Shriver testified before the Energy Committee in 1965, I asked him how are we gong to know what does work and what doesn't work and he swore on a stack of Bibles that they were going to evaluate all these projects and programs and, of course, they never did. And we are still here today trying to defend the various job programs that were terrific in my opinion, but we never really documented our case on any really scientific basis and we never proved that, by golly, even a 40 or 50 percent success rate with that constituency was a bloody miracle.

It seems to me that out of this—if one thing comes out of this 2-day conference, it will be well worthwhile—and a whole lot of things are coming out of it I'm sure, but some kind of systematic review of experimental programs like this to help us replicate what produces success and help us cut out and exorcise with a surgeon's scalpel those elements that produce failure and make that available to cities and States around the country.

Mr. McNamee. I suspect that some of you will want to comment on that and might even point out that maybe some Federal rules and Federal restrictions have kept from doing that exact sort of surgical examination.

Bob Kuttner, before you get into the topic of workfare, I've got a couple of questions that say, in essence, what's the difference between workfare and public service to repay a grant, and if wages are the only difference in reality, how can we justify "employing people" at "wages" below the poverty level, as workfare does?

Mr. Kuttner. If I understand the question, I think there's all the difference in the world between workfare and a wage subsidy. Under the Swedish program, or the one version of it that we have at the State level in the United States which is in Minnesota, the public subsidy goes to the employer to subsidize, to defray part of the cost of the wage. So the recipient is not in the demeaning position of receiving a welfare check with all of the trappings of police authority that go with being able to collect that check, but he's a worker just like any other worker in the private sector with the fringe benefits and relationship with the private employer that anyone else would have, but part of that wage is being subsidized by the State program. So it's like night and day.

I was just going to reinforce something that Jerry McEntee said earlier. All of this stuff, in order to work, requires a full employment context. I mean, if you recall, World War II when unemployment was about 2 percent, everybody and his dog got a job. People who didn't have skills learned skills on the job. Women and minorities got jobs that they had been precluded from taking before. All because the economy needed workers and in Massachusetts, which happens to be my home State, we have this successful voluntary employment training program rather than workfare program mainly because employers are hanging from trees trying to find workers.

My wife is involved with one of these programs. She's able to place people with backgrounds of mental illness in jobs where they would not have been considered years ago just because there are not enough workers. And McDonalds is paying $5 an hour. And that's kind of the best version of the Phillips Curve. That's private industry paying decent wages for low-wage work because you can't get somebody to work for $3.53 an hour.

So I think the macroeconomic context that was first identified in the Employment Act of 1946 is very important, but within that you need these targeted special programs too. But its the full employment context that makes all these things flower.

Mr. **McNamee**. Aren't we then caught in a circle that we've got to solve the macro problem before we can solve the micro problem?

Mr. **Kuttner**. No. I'd say both. If I can take just another minute, the whole experience in Scandinavia is that by having these micro-labor market tools you get to full employment without overheating the whole economy. You cheat the Phillips Curve. So the macro and the micro reinforce each other but they are part of a common strategy of full employment.

Mr. **McNamee**. Mr. Meyer.

Mr. **Meyer**. Well, I'd like to respond to a comment that Congressman Scheuer made because I think it's right on target. I think what we need is exactly what he mentioned, which is a program-by-program analysis of what is working, and within programs what parts and what strategies are working and what aren't, and to target our spending accordingly.

The problem is that because we have defined as the arena in which that process can play out only a very small part of the budget, there really isn't the room to maneuver for this kind of finesse and proper judgment. When you really look at Gramm-Rudman, you see that the amount of cuts that have to be made if the mandatory spending cuts are triggered by an impasse are going to be made in such a small area of the budget that you will pretty much have to eliminate the programs, irrespective of whether they have worked well or not.

Let me just finally comment that I think I made it clear in my talk that I do not advocate means testing of social programs like social insurance and Medicare. I've had useful discussions with groups like the AARP and other groups representing senior citizens about ways of resolving the dilemma that Mr. Kuttner mentioned. It is a tough problem. But I think those groups are receptive to an honest dialogue about measures that could be taken to ask a little bit more of the higher-income elderly, particularly if some of those funds are used to help the lower-income elderly.

We have SSI recipients in this country, as you probably know, that receive three-fourths of the poverty line, even if they have no other income, at the same time as we have these other benefits untaxed or partially taxed. I think there are some tradeoffs there.

They are tradeoffs that don't necessarily infuriate interest groups, though they won't be easy.

I guess my point is that if the political benefits of making these social programs untouchable are so great, then we ought to raise taxes to pay for them. It's just unfair to give Americans the tax cuts and then say we're afraid to face you on the benefits side.

Mr. **McNamee**. I've got a number of questions about making transitions. For the first one, I'm going to exercise my prerogative to make it mine. Is anyone doing a good job of dealing with the marginal tax rate question? Is there a program anywhere? Can anyone cite me an example of a good approach to reducing the 100 percent marginal tax rate that many AFDC and other recipients would face when they go to work?

Mr. **Kuttner**. Real simple. You have universal citizenship programs and the problem disappears. A Medicare person doesn't face that. A public school child doesn't face that. But a Medicaid family does and an AFDC family does. It's inherent in a program that you have to be certifiably poor to receive the benefit.

Ms. **Bane**. You can also reduce the tax rate below 100 percent which is not all that complicated to figure out. In AFDC it used to be that the tax rate was much less than that under the old 30⅓ rule. That was probably better than what we've got now.

Mr. **McNamee**. The clock is catching up with all of us. There's one quick question that I would like to get all the panelists to address, and I will start with Jack Meyer because he addressed it in his paper: What's the appropriate fiscal and directive role of the Federal Government, and how much should be left to the States and the local governments?

Mr. **Meyer**. Well, I think we reached the problem in this country where by the end of the 1970's the Federal Government probably had on its plate more than it could handle, some 500 categorical programs, all the money coming through Washington back out to the States and localities, and I think the Federal Government was involved in some things that could be better done locally.

Examples involves some urban revitalization programs or downtown renewals where if it isn't done federally, the local area could do it.

The problem is that we got such a backlash against the 500 categoricals that Government has gotten a bad name for doing anything. I think we need to sort out what is the legitimate focus of the National Government from the local and State government.

In my view, the basic criterion should be that there are some problems that are rather universal across the country. If you're hungry in one State, it's about the same as being hungry in any other State. If you have no health care in one State, it's about the same as having no health care in any other State, and so on.

Therefore, to me, the Federal Government has a legitimate role in assuring a basic adequate minimum in areas like housing, nutrition and health care. And I think it also has a legitimate role in assuring equal opportunity.

But in many of these other community development areas, we could probably have more local options, more local choice and local determination.

Mr. **McNamee**. Quickly, Ms. Bane.

Ms. **Bane**. Someone pointed out to me the other day that for a Government official the very best programs are those that are paid for by some other level of Government and administered by your level of government and I think I will probably support that, although I would agree with Jack on the national responsibility for income transfer programs and the desirability of State and local innovation and experimentation with many of the more difficult educational training job programs.

Mr. **McNamee**. Professor Gwartney.

Mr. **Gwartney**. My view would be 180 degrees from Mary Jo's with regard to this point. If in fact we want economic efficiency, which I think we should give some weight to, we would be better off if the unit administering the program or conducting the program was also paying for it.

Obviously, an implication of that is that I think experimentation that goes on at the State level is desirable. We learn from these things and they should be encouraged rather than discouraged.

Mr. **McEntee**. I guess the only comment I would make—and I'm sure that the States and the levels of local government can do some things better than the Federal and the Federal can do some things better than the others. I think if we're talking about a country where there is full employment, I think the Federal Government has to play by far the major role in any kind of jobs program. Why we don't have it when we have the kind of crumbling infrastructure that we have all across this country where meaningful jobs could be created, where they could infuse the engine of the economy, is beyond me.

But in terms of the Federal Government turning over these programs to the States, we did have any number of programs turned over early in the Reagan administration and then they had that New Federalism as Ronald Reagan traveled across the country and spoke at various State legislatures about the programs that would be returned to the States, they would be closer to the people and this would be the New Federalism. Can you imagine if they were successful in turning over all those programs then that they were talking about and then we had Gramm-Rudman? And that's kind of nightmarish.

So without guarantees of dollars, the whole thing is just so frightening to me.

Mr. **Kuttner**. I want to turn the tables and ask Congressman Obey something. If I were wearing my reporter hat at the moment, I think the story of this symposium so far, the lead would be that a remarkable diversity of expert philosophical and ideological opinion thinks that the Gramm-Rudman approach is philosphically insane, that a tax increase is necessary, and a significant portion of expert opinion thinks that social programs have been cut enough and that maybe the defense budget ought to be cut.

I guess my question to you, as someone who has to face the voters, and I don't, is whether a significant body of your colleagues has the nerve to face the voters on that program, raise taxes, do anything possible to throw sand in the gears of the Gramm-Rudman machinery, and exempt domestic social spending from further cuts and go after the bloated defense budget. Is that really a politically unsalable program?

Chairman **Obey**. Well, let me respond this way. I do believe—I have to or I wouldn't stay here—I mean, very frankly, since 1978, most of the fun has gone out of public service because the institutions of Government and the political leaders who occupy those institutions have not sufficiently faced up to the realities of the numbers and that means growing frustration on the part of people back home.

I continue to believe that there exists within the Congress sufficient will to deal with that core problem, provided that it is done on an instrument which is real rather than something as ephemeral as a budget resolution which does not have the force of law until it's followed up.

But I also believe that you are not going to have that happen because it is impossible to put together in this country—the way our political system is structured, it is impossible to put together a political consensus requiring the support of both political parties without the active promotion and support and selling and education by the President of the United States.

And I don't mean to suggest that all of the mistakes lie on his side because I do believe that we have had in my own party as well a refusal on occasion to face realities in terms of some of the hard choices. But I do think that the realities of the last 6 years have made virtually every philosophical group in the Congress aware of the fact that the numbers don't match.

The question is whether we will be able to continue the efforts that people—if I can toss in a bipartisan comment—that people like Pete Domenici and Bob Dole have tried to encourage on the Senate side but for which we have not had the kind of support we need in the White House frankly.

I asked one person yesterday close to the administration on this issue whether they felt we would get this grand compromise this year. I said, "Are we going to get an agreement which—do you think we can get the President to give on revenues and military if the Congress gives on some of the entitlement fences?" And the response I got was, "No. The President isn't going to give on revenue." So I would simply say what Paul Sarbanes said yesterday, that without the active understanding, acquiescence, promotion and leadership by the President, we're not going to get it. And that's the gut question.

Senator **Sarbanes**. Would you yield for a comment?

Chairman **Obey**. Sure. I just want to make one more point. People who voted for Gramm-Rudman—and I was not one of them. I attended 74 meetings during its construction which was enough to make me vote against it. But there were two groups of people who voted for Gramm-Rudman: One, because they really wanted to disarm Government's ability to do much of anything in this system and this society; and another group of people who voted for it because they thought it was the only way that you could force the the White House to face reality, that the numbers demonstrate that you have to put aside ideological first preferences and simply deal with the issue on both the revenue and the spending side.

And the test will be whether they were proven to be right. I am skeptical, but I hope they will wind up being right.

Mr. **McNamee**. Senator Sarbanes, you will have what will have to be the last word on the topic.

Senator **Sarbanes**. I want to carry Dave Obey's remarks forward in two areas. One, I said yesterday and I say it again today, if you had been asleep for the last 5 or 6 years like Rip Van Winkle and awoke to find the economic circumstances that the country now faces; if you looked at all the policy options and then were told that the country had a President who ruled out both additional revenues and any action in the defense area as means of addressing the dilemma, you would say he's not being responsible in facing the Nations's problems.

It's legitimate to turn to the Congress and say the Congress should be responsible; we ought to be more responsible than we are. But the notion that the Congress can substitute for an irresponsible executive defies, I think, the American political system and American political history.

When did the Congress ever raise taxes when the administration was not pushing for a tax increase? It's hard enough to do even in that circumstance. Now its being suggested that Congress ought to undertake to raise taxes over the opposition of the President and the administration, and the President saying he will veto such a measure if it's passed. This means in effect that if he holds onto only one-third of one House he can sustain his position.

The other point of Dave Obey's that I wanted to carry a little further is this: he said earlier that if you target a program too tightly to the poor you lose the political constituency to support that program, I think he's identified a very real problem.

But I'd like to add a further complication to it I think that if you overly target a program and create a sense that the people being helped are outside the mainstream, not only do you undercut the political constituency to support the program but you place the people benefiting from the program in a psychological context that to some extent almost guarantees the program with fail. You have then singled them out in a society in a way that runs contrary to all of our basic precepts about equality and the individual and so forth.

And that's why some of these programs are stronger when they take a broader approach or are cast in a different framework. I like what Bob Kuttner has written about new ways to a formulate an education program, or housing that goes to first purchasers, so that we break out of the old molds. Then, in effect, the people participating in the program don't feel that any blame or onus is being cast upon them; they don't sense it and the society at large doesn't sense it. I think the program then has a greater chance of producing results to the benefit of all.

Mr. **McNamee**. Well, whatever you think about Gramm-Rudman these days, I tend to think of it as a black hole. Everything gravitates toward it. It's inescapable. And there's not a whole lot of light coming out.

I think that concludes our panel. I think we owe them all a round of thanks for an excellent set of presentations.

[Applause.]

Chairman **Obey**. Let me thank Mike for his work here today and make just a couple of announcements before we break.

First of all, I again want to introduce some people in the audience who are here with us again today. Leon Keyserling who really was here at the founding of the Employment Act.

[Applause.]

Chairman OBEY. And two former Members of Congress who have paid throughout their careers a great deal of attention to economic problems—there were three—I know Hastings Keith was here. I don't know if he is still here but I saw him earlier, and you have in the front row Congressman Henry Reuss, who used to chair this committee.

[Applause.]

Chairman OBEY. And Congressman Joe Fisher who before he served in Congress served in a staff capacity at the Council of Economic Advisers, as also Paul Sarbanes as you know.

[Applause.]

Chairman OBEY. Second, I am told that there are a limited number of seats available for the luncheon at which we will hear from Jerry Jasinowski from the National Association of Manufacturers, and Fred Bergsten, Institute for International Economics, on America's place in a growing world economy. So if any of you are interested in attending that, we will have a limited number of seats available in 1100 Longworth, which is the Ways and Means Committee hearing room, and we will resume this session at 2 o'clock.

[Luncheon recess.]

LUNCHEON SESSION

Chairman OBEY. If I could have your attention, please, I'd like to move right along on the luncheon program.

Let me quickly introduce those at the head table. We have introduced them at the conference several times already but for any of you new faces who wandered in, we have, running from my left to the right at the table, Leon Keyserling, Congressman Jim Scheuer, Jerry Jasinowski, one of our speakers; and skipping the next person for a moment, former Congressman Henry Reuss of Wisconsin.

My job at this luncheon is very simple. I would like to introduce one person in the audience, another Member of Congress who's been attending this conference religiously who's shaking his head because he doesn't like to be recognized, which is rare, Tony Beilenson from California.

[Applause.]

Chairman OBEY. My job is simply to introduce Senator Paul Sarbanes who will introduce our two main speakers. As you know, Paul has a distinguished career in public life and in private life. He began rather humbly as a Rhodes Scholar and then graduated to the Council of Economic Advisers where he served as the staff assistant to Walter Heller. He then stepped down a bit and was elected to the House of Representatives for 6 years and in 1976 was elected to the U.S Senate. Today he serves as the ranking Senate Democrat on the Joint Economic Committee.

I give you Senator Paul Sarbanes of Maryland.

[Applause.]

Senator **Sarbanes**. It's a pleasure to have the responsibility of introducing our speakers today at lunch. They are two of our country's leading authorities on the U.S. role in the world economy.

Fred Bergsten is currently the director of the Institute for International Economics and Jerry Jasinowski is a vice president and chief economist for the Naitonal Association of Manufacturers.

Both are at the center of the continuing debate about the nature of the challenges facing the U.S. economy and the appropriate U.S. response, and both of them have made important contributions to international economic policy.

Just for a moment, reflecting over the 40 years of the JEC which this anniversary symposium commemorates, I think we are inevitably struck by the profoundly changing role of the United States in the world economy.

Forty years ago, when the JEC was first established, the United States was indisputably the world's single economic superpower. The Marshall plan was initiated by the United States for the purpose "of furnishing material and financial assistance to the participating countries in such a manner as to aid them through their own individual and concerted efforts to become independent of extraordinary outside assistance." It was, in fact, U.S. policy and investment that to a large degree made possible the industrial development and economic expansion that has literally changed the face of the globe.

Our current dilemmas are very different from those of 40 years ago. For the first time since before World War I, the United States is today a debtor nation, with a trade deficit exacerbated by an overvalued dollar, and Japan has now replaced us as the world's leading creditor nation.

The framework for ordering international trade and finance so painstakingly established after World War II has been strained as international economic relations and the U.S. role in them have changed in fundamental ways.

Our two speakers are especially well qualified by background and experience to review the U.S. role. Both have served with distinction in public as well as private capacities.

Jerry Jasinowski was a member of the Joint Economic Committe staff from 1972 to 1976. He served as Assistant Secretary of Commerce for Policy in the following 3 years, and joined the National Association of Manufacturers in 1980 as chief economist and vice president.

Fred Bergsten has been a senior associate of the Carnegie Endowment, with Brookings and the Council on Foreign Relations, served as Assistant for International Economic Affairs of the National Security Council, and was Assistant Secretary of the Treasury for International Affairs of the previous administration before becoming director of the Institute for International Economics.

We will hear from each of them for approximately 15 minutes. That will leave us some time after their remarks for questions before we resume the afternoon session. And adopting the time-honored alphabetical manner of procedure. I'm pleased to present to you now Fred Bergsten; and when he finishes Jerry Jasinowski will come to the microphone.

[Applause.]

LUNCHEON: AMERICA'S PLACE IN A GROWING WORLD ECONOMY

PRESENTATION OF C. FRED BERGSTEN

Mr. **Bergsten**. Thank you very much, Paul. It's a great pleasure to be in this distinguished group and participate in this very distinguished symposium for which I congratulate you, Chairman Obey, and the rest of the members of the committee.

Today's topic is America's place in a growing world economy and, unfortunately, as we all know and as Senator Sarbanes just said, America's place in that world economy has been deteriorating at an incredible pace and has become extremely weak and, I would submit, extremely vulnerable.

Our current account deficit in 1985 was about $125 billion, much larger than the current account deficit of all the developing countries taken together in 1981, the year before their debt crisis broke out.

Net capital inflows of a like magnitude were, of course, needed to finance that deficit and increased the foreign debt position of the United States accordingly.

As a result, the United States has become a debtor country, frittering away its position as the world's largest creditor accumulated over 65 years in just 2 years. As a result, the United States will shortly become the largest debtor country in the world, substantially exceeding Brazil and Mexico, at about $100 billion each the current leaders in that dubious competition.

We, in fact, have accumulated more net foreign debt in each of the last 2 years than the cumulative historical total of either of those major, "profligate" debtor countries.

The United States at this moment continues to go into net foreign debt faster than any country in recorded history.

Despite all the rhetoric on this topic, it may have escaped you that U.S. imports now exceed U.S. exports by more than 50 percent. That compares with about 10 percent for Mitterrand's France in its dash to grow earlier in this decade that led to its crisis, and it's much more than the 20 percent excess of imports over exports that the major debtor developing countries experienced back in the early 1980's before their debt crisis erupted.

So the United States now faces a situation where our exports are going to have to start growing twice as fast as our imports just to reverse the trend of deterioration, let alone ever get us back to anything like a reasonable external position.

I would submit, therefore, that the United States is experiencing a sweeping historical change in its international position, perhaps one of the most important structural changes to be experienced by the United States in the entire 40-year history of the Joint Economic Committee.

So the international position of the United States is bad and getting worse at an incredible pace.

But you might immediately say, how can that be? Isn't the U.S. economy in fact doing rather well? Haven't the results of the 3 or 4 years been on the whole quite impressive?

There was indeed a view in the early 1980's that recovery would be impossible with a huge budget deficit because that would put pressure on interest rates, crowd out private investment, and therefore recovery was impossible. That view, of course, was clearly belied.

There was another view that said it would be impossible for the United States to get rapid economic growth going again and get unemployment down without regenerating huge inflationary pressures. A lot of economists took that view and it, too, has been defied.

So how did it happen? I think we now know the miracle of supply side economics. The miracle is that the foreigners supply a large part of the goods and the foreigners supply most of the money. Without the huge influx of capital from around the world, the U.S. recovery of the last 3 to 4 years simply could not have occurred. The fact is that capital imports exceeded 3 percent of our gross national product last year, either financing more than half of the Government budget deficit or financing more than half the increase in all gross investment in the economy through the recovery period; and that without those huge capital inflows, U.S. interest rates, on my colleague Stephen Marris' calculations, probably would have been about 5 percentage points higher than they turned out to be and, therefore, the recovery could not have occurred.

That is an indicator of both the critical interdependence now between the United States and the rest of the world and also an indicator of the degree of vulnerability that we face in our own external position.

In my view, what has happened over these last 3 to 4 years has built an enormous legacy of vulnerability and U.S. dependence on continued support from the world economy. It has led us to a position which is so negative that we clearly need to begin very rapidly an adjustment of our external position lest the entire house of cards come crumbling down.

I am not going to belabor the costs of the overvalued dollar and our trade deficit. You are familiar with that in terms of lost jobs, in terms of production shifts from United States to foreign subsidiaries of our firms, many of which may be irreversible. You are familiar with the costs of becoming a net debtor country. Instead of earning $30 to $40 billion of income as we were only 3 years ago, we are now going to be paying a like amount and even higher amounts in the years ahead.

I would submit that, in addition to these heavy costs, our external position is not only huge and growing but it is fundamentally unsustainable in two very different senses.

One sense in which it's unsustainable is that investors around the world are very unlikely to continue to put $100, $150, ultimately $200 billion a year into the U.S. economy each year without fearing that at some point the dollar will decline sharply and therefore a rapid and hard landing would occur.

But perhaps even more proximately, I think the situation has now been demonstrated to be unsustainable in internal political terms within the United States because with the trade deterioration of the type we have seen an outbreak of protectionist trade pressure would become inevitable.

If one studies the history of U.S. trade policy, particularly throughout the postwar period, one finds that by far the most accurate leading indicator of protectionist trade pressure in this country is not the unemployment rate but, rather, the exchange rate of the dollar. It's when the dollar has become substantially overvalued, as in the late 1960's and early 1970's, again modestly in the mid-1970's, and with a vengeance these last 4 or 5 years, that the pressure for trade protection grows enormously.

For the latest evidence, look at the latest period. The U.S. economy boomed in 1983 and early 1984 and growth has continued since then, but protectionist pressures have continued to rise and indeed application of protectionist measures has also continued to rise.

So the internal instability seems to me to at least rival the external instability and indicate why, whatever one thinks of the desirability of our international position, it is unsustainable and cannot last.

And so it seems to me on grounds of both desirability and inevitability, there will be a huge correction in the external position of the Unted States. The question is, how it happens and when it happens and what its costs are as it occurs?

Now that, of course, asks the question, why did we get into this state at all? Again, I won't belabor it because time is short. But there are three different theses that are put forward to explain this enormous deterioration of the U.S. external position.

One suggests that there was a fundamental lack of competitiveness in American industry and labor, that our productivity has slumped, our inability to compete is structural and lasting, and both preceded and will succeed any movements in macroeconomic variables.

I would certainly share the view that the United States has to do everything it can to increase its very low savings and investment rates, beef up spending on research and development in particular to improve our competitiveness, and certainly look at any proposed tax changes very much in the light of what they will do to our international competitive position.

But as I look at our underlying structural position, my own conclusion is that it is rather strong because if I go back to the last period before everything was distorted by currency overvaluation, namely, the late 1970's, I find that the United States was doing extremely well in international trade. From 1978 to 1980, U.S. exports grew twice as fast as world trade. We regained market share in every single sector of manufacturing industry, in some cases back to levels not seen since the 1960's. Our current account position improved by $60 billion in just 2 years, excluding the direct price effect of the second oil crisis.

So if you go back to the last period before the enormous price distortions, I would submit the United States was doing rather well, and that indicates an underlying position that is quite strong.

Again, not to be misunderstood, we need to do everything we can to improve our productivity further, particularly our low investment level, but I would not find much of the blame lying with the underlying competitive position of American industry and labor.

A second thesis that is suggested has to do with foreign trade barriers. Some would argue the United States is running a deficit because the foreigners are keeping us out of their markets. Again, every effort clearly has to be made to open markets around the world to our own exports in a reciprocal trading manner.

But here, as many of you know, we have done some detailed empirical work at the institute. We published a study on the United States-Japan aspect of it only a few months ago, Japan being regarded as the most egregious case of holding out American goods. There we found that there is indeed a significant reduction in U.S. exports, perhaps on the order of $6 to $8 billion a year, because of existing Japanese trade barriers. But that, of course, is only a small fraction of our $50 billion deficit with Japan, let alone our global deficit of three times that level.

And when you consider the fact that we also found that U.S. controls are keeping out Japanese exports to this country, also by something like $4 to $5 billion, and our own export controls restrict what we could sell to Japan, particularly Alaskan oil, then waving a wand and going to a world of free trade on all sides probably would not change the accounts very much.

That then leads to the conclusion that the main cause of the problem has been the strength of the dollar. Depending on one's index, the IMF or the Federal Reserve index, the dollar rose in value from 1980 to its peak of just about a year ago by 55 to 88 percent.

Now if you were a company and your prices rose compared with your competitor down the street by 55 to 88 percent in 4 years, you know where you would be—in or very close to chapter XI bankruptcy status. Yet, that's what basically happened to the United States as a country against the whole universe of other competing countries that we have to deal with every day in world trade.

I would submit that, at its peak about a year ago, the dollar was overvalued in terms of our underlying trade competitiveness by about 40 percent. That was, of course, the equivalent of taxing all our exports by about 40 percent and subsidizing all imports coming into the country by about 40 percent. There are lots of good econometric studies that show for every 1 percentage point decline in our international price competitiveness, through the exchange rate or elsewhere, our trade balance deteriorates by about $3 billion. So it's not hard to explain how we have seen such an enormous growth in the U.S. trade deficit with the dollar having risen to the extent it has over these past 4 to 5 years.

Now what to do about it? Over this past year, the exchange rate of the dollar has fallen by about 20 percent, again plus or minus a bit depending on your index. So on the calculations that we have tried to do, about half of the dollar overvaluation has been corrected.

Unfortunately, that is not nearly enough. I've had a table handed out here to you at the meeting which shows the outlook for the U.S. trade and current account position—in billions of dollars, not millions as the headnote says—with the exchange rates as of Wednesday of this week. What that table shows is that, despite the substantial decline of the dollar over this last year, we are still on a path of deterioration in our international trade and financial position. And if there was no further correction in the exchange rate relationship, our current account deficit would continue to rise to something like $200 billion annually by the end of this decade and our net debt position would grow to something like $1 trillion.

That's less bad than it was a year ago. At that time we were on a path headed toward a current account deficit of $300 billion at the end of the decade. But as of now, it's still deteriorating and much further correction is needed.

My own reading is the dollar has to correct by another 15 to 20 pecent to get the United States external position back to anything reasonably approximating external balance. It's got to be done in an orderly way in order not to trigger a dollar fall that is worse than the disease, creating a massive runup in inflation and interest rates. What that really says is that we need to do it sooner rather than later because the longer the adjustment, which is inevitable, is postponed, the more likely a precipitous decline and a hard landing.

The first step that's needed is, therefore, to maintain the initiative undertaken so correctly by the United States and the Group of Five in September of this year. They are meeting over this weekend. I think it's critical that they take further steps to achieve the further correction that is needed. I don't know whether they can get much further progress with only the kinds of measures taken so far—announcement effects, intervention in the exchange market. There were those who were surprised that the measures they took were able to achieve even as much as they did. I did not share that view because I though the last part of the dollar runup was clearly a speculative bubble unrelated to any underlying fundamental and that bubble could be burst by the kind of Government initiative and intervention that occurred. So far, it has succeeded.

But now we clearly need more effort on the fundamentals. The first step is to move interest rates down in this country. I would submit that that is called for and fully justified on purely domestic grounds. The need to get further dollar correction adds substantially to that case.

But ultimately what, of course, must be done is that the members of this body, along with the administration, must act to substantially reduce the budget deficit. That is, after all, whose growth has meant that we are spending more than we are producing, investing more than we are saving, and therefore has underlain this entire external imbalance.

I would share the view of several speakers on yesterday's program that we need not eliminate the external deficit, but we need to get very close to doing so to deal with the trade problem.

I would finally make one point about the longer-term implications of the current dollar problem, an implication that I think is particularly relevant for a discussion here in the Joint Economic Committee because it's an issue which the committee addressed under the leadership of Henry Reuss in one of its finest performances all through the 1960's and early 1970's. It has to do with the functioning of the international monetary system and, indeed, it was Henry Reuss who led intellectual understanding around the world, 5 years before most people got there, that the old fixed-rate system of Bretton Woods itself was unsustainable.

We have now learned that the world of flexible rates is not so ideal either. What we need is to find a synthesis between the excessive rigidity that came to dominate the old fixed-rate system and the excessive volatility and overshooting of the current flexible rates, something like a regime of target zones in which the major countries would agree to keep their rates within reasonable ranges of underlying competitive reality but still let the market dominate in the short run as long as rates did not get more than 10 or 15 percent away from their underlying equilibrium. That, it seems to me, is the long-term aspect of the dollar and trade problem to which we must also address ourselves and to which I hope and expect the Joint Economic Committee to continue its leadership.

Thank you.

[Applause.]

[The complete presentation of Mr. Bergsten follows:]

WORLD GROWTH AND AMERICAN COMPETITIVENESS:
A PROPOSED STRATEGY

A Paper Prepared for the
Joint Economic Committee
of the US Congress

by

C. Fred Bergsten
Director, Institute for International Economics

December 1985

The Outlook for World Economic Growth

The growth of the world economy has slowed substantially. After averaging more than 5 percent in the 1960s, global growth dropped to 4 percent in the first half of the 1970s, 3 1/2 percent in the second half of the 1970s and to about 2 percent in the first half of the 1980s. A central question is whether this sharp decline is based on permanent changes in underlying growth potentials and is thus likely to persist--or whether, on the other hand, temporary factors and/or faulty policies are to blame and a recovery toward previous levels can be realistically pursued.

Some of the rapid growth of the 1960s clearly stemmed from nonrecurring phenomena. Europe was still completing its recovery from the Second World War, the launching of the Common Market (1958) probably provided a one-shot spurt and most European countries imported large numbers of foreign workers to achieve maximum output. Japan emerged for the first time as a global force in the 1960s, telescoping its postwar recovery into an expansion of over 10 percent annually throughout the decade. The United States also experienced a recovery, in its case from the mediocre performance of the late 1950s, and expanded rapidly in the middle 1960s under the joint stimuli of the Vietnam War and Great Society buildup.

A number of these factors were inherently temporary, and some slowdown in the 1970s was to be expected. In addition, however, the growth success of the 1960s sowed some of the seeds of its own subsequent demise: the onset of substantial inflationary pressures and sharp rises in governmental expenditures (which led to large budget deficits when growth slowed). These developments were compounded by several key policy errors in the early 1970s, notably excessively expansionary monetary policies and a failure to adjust exchange rates in time to avoid collapse of the Bretton Woods monetary regime. The first dramatic rise in oil prices and the simultaneous jump in world food prices further exacerbated inflationary pressures in the early 1970s and prompted a shift to much lower rates of economic expansion.

World inflation rose sharply again in the late 1970s, and the second oil shock closed the decade. Anti-inflation efforts were redoubled almost everywhere, and growth fell sharply--to around 1 percent annually during 1980-1982. A major element was the swing from sharply negative to sharply positive real interest rates, which--along with the recession itself--triggered the Third World debt crisis and dampened global growth further. The high cost of accumulated policy errors from the past, including the onset of excessive government intervention and other structural rigidities in both industrial and developing countries, was laid bare by the onset of adverse macroeconomic conditions.

This quick reading of recent economic history suggests that part of the decline in world growth can be traced to natural and permanent shifts, and that we should not expect to return to the 5 percent expansion of the late 1960s. However, an important part of the slowdown represented a reaction to the previous excesses themselves. Moreover, policy errors--particularly in permitting inflation to explode and government spending to rise on the assumption of indefinite self-financing growth--intensified the retrenchment. So neither should we be satisfied with the 2 percent expansion of the recent past.

Recent studies by the OECD and Wharton Econometrics suggest that world potential output is now growing by about 3 percent annually. In addition, the slow growth of the past five years has produced "output gaps" ranging between 5-10 percent of GNP in all the major countries and unemployment rates which remain quite high by historical standards.[1] This suggests that one-shot "catchup" growth periods, in excess of sustainable annual growth paths for the long run, are feasible almost everywhere.

Such a period was already experienced in the United States during 1983 and the first half of 1984 (with real growth averaging more than 5 percent), and unemployment is probably closer to its long-run equilibrium level in the United States than in the other major countries. This indicates that such catchup periods are feasible. It also indicates that the bulk of the catchup effort in the future should probably come from major industrial countries other than the United States.

[1] "World Financial Markets," New York: Morgan Guaranty Trust Company of New York, December 1985.

It would therefore see that the world should be aiming for (1) a short period of growth above the long-term norm, say 4-5 percent annually for two or three years, led by the industrial countries other than the United States and (2) steady expansion of 3 percent on a lasting basis. Indeed, perhaps the most surprising developments in the recent past are the failure of the other industrial countries to enjoy a catchup period similar to that experienced by the United States in 1983-1984 and the failure of all countries (perhaps including the United States) to return to a more rapid rate of ongoing expansion.

Renewed Inflation?

There are only two (closely related) possible explanations for such an outcome, assuming that this analysis of economic potential is basically correct: a failure by the major countries to recognize that the opportunity for more rapid expansion exists once more, or an unwillingness to risk renewed inflationary difficulties even if they discerned the presence of such opportunities. The key issue is thus whether inflation has in fact been wrung adequately from the global economy to permit more rapid economic growth without reigniting the dreary stop-go cycle of the past fifteen years. The answer, at least for the three potential locomotives (the United States, Japan, Germany), would seem to be unambiguously positive.

To be sure, inflation remains exceedingly high (and even rising) in some important developing countries. Consumer prices have until quite recently still been climbing by 5 percent or more in such industrial countries as France, the United Kingdom and Italy. Even the lower rates recorded in the Big Three do not represent a total victory over inflation (though Japan and Germany will probably experience zero or negative inflation for a period as a result of the recent and probably further appreciation of their currencies).

But inflation has come down dramatically from the levels of the 1970s. Even more importantly, the inflation outlook is for continued declines or at least no upward movement:

-- Wages are behaving well, and are continuing to run below the CPI increase in the United States; even with the growth rates suggested here, unemployment rates will remain high by historical standards and limit upward pressure on wages.

-- Commodity markets remain depressed and the outlook is for further declines--possibly sharp declines--at least for energy prices, by far the most important in affecting global price levels. Indeed, the possibility of a "reverse oil shock" add importantly to the potential for a resumption of faster world growth with subdued inflation--a reversal of the conditions of the 1970s.

-- Increasing global competition, which can be preserved (and even spurred further) by policy measures (see below), will help moderate tendencies for prices to start rising again.

-- No country will forget the heavy costs levied by recent inflation and the necessary policy responses to it, and adjustments to head off any recurrence of the phenomenon can be confidently expected.

The single sign of renewed inflation risk in the near term is the above-target rise of M1 in the United States. However, the utility of M1 as a predictive tool has been sharply reduced because of large shifts in the velocity of money. M2 and M3 are within their target ranges. Moreover, the monetarist models which focus on these variables have been largely discredited with the failure of their predictions for more inflation in 1982-1983 and again throughout 1985.

It must be recognized that the United States could experience a temporary increase in inflation while the exchange rate of the dollar declines to a range compatible with restoring equilibrium in our external accounts. However, this natural "re-importation" of some of the price pressures exported via dollar appreciation in 1980-1984 will disappear once the new equilibrium is achieved, and inflation will drop back to the underlying or "core" level. Moreover, the absence of any significant inflationary impact from the 20 percent decline of the dollar over the past nine months is encouraging.

As a long-run proposition, continuation of high budget deficits in the United States would raise the specter of eventual monetization and thus a rekindling of inflation. Though decisive action remains to be taken, the combination of the budget resolution for FY 1986 and Gramm-Rudman-Hollings has at least begun the corrective process. Moreover, from a global perspective, budget deficits have been reduced substantially in the other leading industrial countries (Germany, Japan, United Kingdom)--indeed, by an amount greater than the increase in the American deficit over the past five years. Once the United States gets its house in order, OECD-wide fiscal policy will in fact add to the unlikelihood of renewed inflation.

The main obstacle to a restoration of more rapid global growth is thus that policymakers in most countries, like the apocryphal generals, seem to be fighting the last war. Real interest rates remain extremely high in virtually every country, currently approximating 4-5 percent here. Budgets are being tightened almost everywhere, whether appropriately (as in the United States) or even though sizeable structural surpluses have already been achieved (as in Japan and Germany). Partly as a result of continuing high unemployment and partly due to the huge currency misalignments, protectionism is rising despite its adverse effects on both growth and price stability. Capital flows to the developing debtor countries have largely dried up, just when they are most needed to support a resumption of growth both there and worldwide.

There is thus considerable potential for restoring a more satisfactory rate of world economic growth without rekindling inflation or inflationary expectations. Before turning to specific proposals for doing so, however, I will address the second major question raised by the Committee: the barriers to improved competitive performance by American industry in world trade.

American Competitiveness in World Trade

The international competitive position of the United States has deteriorated dramatically in the 1980s. Our trade deficit will reach about $125 billion in 1985 on a balance-of-payments basis, and probably about $140 billion on the Department of Commerce basis with imports recorded c.i.f.--an increase of $100 billion from 1980-1981. Even with the sharp decline of the dollar since last February, the outlook in mid-December (with the yen at 200:1 and the DM at 2.50:1) was for steady further growth in the deficit--to perhaps $140 billion in 1986 and $175 billion annually (balance-of-payments basis) by the end of the decade. This is because our current position is so bad: imports will exceed exports by 50 percent in 1985, compared with an excess of 30 percent for the seven major developing countries on the eve of the debt crisis in 1982, which means that exports must henceforth grow twice as fast as imports to achieve improvement in the trade balance.[2]

In addition, these huge trade deficits require the United States to borrow heavily from the rest of the world to keep its overall external accounts in balance. As a result, the United

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[2] Stephen Marris, Deficits and the Dollar: The World Economy at Risk, Washington: Institute for International Economics, December 1985.

States has shifted from being the world's largest creditor country (as recently as 1982) to the world's largest debtor country. Instead of earning considerable returns on our international investment position, we will now be paying considerable amounts to our foreign creditors. This means that our current account position, which includes services transactions as well as trade in goods, has deteriorated even faster than the merchandise accounts: from small surpluses in 1980-1981 to deficits likely to exceed $200 billion by 1990 if the dollar correction were to go no farther.

If the United States is to restore reasonable balance in its current account, it therefore needs to go a long way toward reversing the trade deterioration of 1980/1981-1985/1986 and generating enough merchandise surplus to service its sizeable external debt (which will hit at least $400-500 billion, under the most optimistic assumptions, before levelling off). The magnitude of the required correction is on the order of $100-150 billion from where we now stand, more if the adjustment is delayed further.

There are three possible explanations for the loss of US competitiveness: changes in underlying productivity and other competitive fundamentals, rising trade barriers in other countries and macroeconomic circumstances (notably the strength of the dollar). I believe that each factor is responsible for part of the problem and needs new policy efforts, but that the macroeconomic elements overwhelmingly dominate the picture.

In my view, the underlying competitive position of the United States is quite strong and cannot be blamed for much of the trade deterioration since 1980-1981. Indeed, the US international position was improving sharply prior to the onset of dollar overvaluation at the start of this decade. From 1978 to 1980, once the dollar had regained a competitive level, US exports grew twice as fast as world trade. We regained global market share in virtually every category of manufactured goods, in some sectors recouping shares not seen since the 1960s. Excluding the direct price effects of the second oil shock, our current account position improved by $60 billion in just those two years.

During the early 1980s, in the face of both sharp recession and enormous dollar overvaluation, many US export and import-competing industries have recorded impressive productivity gains. As noted in the first section of this paper, wage increases have been modest; indeed, wage freezes and rollbacks have not been uncommon in tradeable goods industries. Costs have been cut by as much as 25-30 percent in key sectors such as automobiles and farm equipment. Foreign firms have been rapidly expanding their investments in the United States, despite the strong dollar. In my judgment, the United States will be extremely competitive once we stop pricing ourselves out of world markets via the exchange rate.

To be sure, every effort should be made by both government and the private sector to improve further the underlying competitiveness of the American economy. We need higher domestic savings and more investment, more research and development, better export finance and a more effective educational system. Tax changes, for example, should be made only with full recognition of their impact on our competitive position. But it would be hard to blame the current problem on these factors.

The second potential explanation for our competitive lag, trade barriers in other countries, also cannot account for much if any of the deterioration of the American trade balance over the past five years. Japan, the major target of such charges, has in fact been reducing some of its barriers while we have been raising ours. In the aggregate, the Institute's recent study of the issue shows that Japan's import controls restrict US exports ($5-8 billion annually) only modestly more than our barriers restrict Japanese exports ($4-5 billion).[3]

Some other competitors of the United States probably have increased their trade distortions in the 1980s, notably some developing countries (mostly in Latin America, due to the debt crisis, but not the rapidly growing Asian countries, which have been liberalizing) and the Europeans and a few others on agricultural products. It is extremely important to attack existing barriers in Japan and elsewhere via multilateral negotiations (see below) and via unilateral action, where appropriate, for trade policy and straightforward efficiency reasons. Set against the increase of $100 billion or more in our deficit, however, these distortions--particularly when compared with the increases in US barriers (textiles and apparel, steel, automobiles, sugar, additional minor products) cannot explain much.

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[3] C. Fred Bergsten and William R. Cline, The United States-Japan Economic Problem, Washington: Institute for International Economics, October 1985.

In my view, macroeconomic factors are responsible for the great bulk of the deterioration in the US trade position over the past five years. Three elements can be identified separately: the "growth gap" due to the spurt in the US economy in 1983-1984 compared with continuing slow expansion abroad, the Third World debt crisis and the enormous rise in the value of the dollar. The "growth gap" added substantially to our deficit for about eighteen months, but growth has been no faster in the United States than in the rest of the OECD since mid-1984; for 1980-1985 as a whole, the higher level of US imports resulting from this temporary differential adds only about $20-25 billion to the annual deficit. Likewise the debt crisis cut sharply into US exports to the Third World in 1983 (from their sharply increased levels of 1980-1981), but this factor accounts for only about $10-15 billion of the total deterioration.

Hence about three quarters of the US trade deterioration of 1981-1985 can be traced directly to the strength of the dollar. The same (or an even more dollar-centered) result also emerges from the standard analysis that every decline of one percentage point in the international price competitiveness of the United States costs our trade balance $2-3 billion, when it is noted that the dollar rose 40-80 percent from 1980 to the first quarter of 1985 (depending on the precise base date and index used in the calculation).

Some causes of dollar strength are either beyond our control or reflect conditions we would not want to change. From the US side these include: the "safe haven" appeal of the United States (in both economic and political terms), our success in reducing inflation, our more rapid economic expansion (in 1983-1984) and perhaps our more attractive tax treatment of corporate earnings. However, the primary cause of the dollar's rise and the trade deficit was the sharp rise in the budget deficit, which produced the sharp rise in American interest rates and hence interest rate differentials which attracted huge capital flows into the dollar throughout this period. In addition, a "speculative bubble" in late 1984 and early 1985 carried the currency far beyond anything justified by "the fundamentals."

The G-5 initiative of September 22 has gone far to burst the bubble. The dollar had already declined by about 10 percent from its late-February highs, so the G-5 in essence "leaned with the wind" to prompt a further correction--which, at this writing, had probably offset about one-half the peak overvaluation of 40 percent. The G-5 has done so thorough a combination of announcement effects, direct intervention and modest reductions in interest differentials.

As noted earlier, however, the US trade and current account deficits will continue to grow unless the currency correction goes a good deal further. (To achieve current account balance for the United States, the rates need to move immediately to at least 180-190:1 for the yen and 2.20:1 for the DM.) This in turn will require action on the fundamentals: sharp cuts in the budget deficit and further reductions in interest rates here, coupled with fiscal expansion in the key foreign countries (especially Japan and Germany).

A reversal of the policy mixes both here and abroad is thus needed to assure adequate and lasting correction of the misalignment. Indeed, any sharp decline in the trade deficit not accompanied by a sharp cut in the budget deficit would produce major new problems for us (and the world economy) by reducing our capital inflows and thus bringing in the oft-predicted "crowding out" of private investment which was averted to date only because foreign savings have been flowing to this country in such large magnitudes.

A Proposed Policy Package

Similar policy prescriptions emerge from my analyses of how best to rekindle adequate global growth--3 percent on a secular basis, with 4-5 percent "catch-up" rates for a couple of years--and how to restore the competitive performance of American industry in world trade. Six steps loom as most important:

First, it is essential to reduce sharply the level of real interest rates--particularly real interest rates in the United States. This will spur growth directly. With larger reductions in interest rates here than abroad, it will also contribute to completing the needed realignment of currencies; this will in turn dampen protectionist pressures and contribute to an easing of Third World debt. Furthermore, lower US interest rates will stimulate investment here and strengthen our competitiveness over the longer run. An easing of monetary policy by the Federal Reserve is central to such an outcome and appears fully consistent with both the internal and external outlook for the American economy.

Second, sharp and steady reductions are needed in the US budget deficit. This would would permit lower interest rates here without risking any rekindling of inflationary expectations. It would also contribute directly to a lower current account deficit for the United States, because fewer foreign goods and less foreign capital would be needed--indeed, it is primarily because of the sharp rise in the budget deficit that we have been spending more than we produce and investing more than we can save. Action is needed to cut the deficit on the scale envisaged in the original agreement between the President and Senate Republicans last spring ($50 billion in FY 1986, $100 billion in FY 1987 and $150 billion--virtually eliminating the structural deficit--in FY 1988), or on the Gramm-Rudman-Hollings path to eliminating the entire deficit by the end of the decade.

Third, Japan and Germany (and possibly the United Kingdom) need to adopt new expansionary measures on the order of 2-3 percent of their GNPs. One third to one half of recent economic growth in these countries has come from the large increases in their trade surpluses, and they will have to stimulate domestic demand to offset the adverse effects on their future growth of the US trade adjustment ($25-50 billion for each) and to boost world growth to the targeted levels. Supply-side tax cuts to stimulate private investment, particularly in housing and other infrastructure in the case of Japan, would probably be most propitious, along with modest easing of monetary policy now and more substantial cuts in interest rates once the currency correction is completed (and to keep it from going too far). Both Germany and Japan have virtually eliminated their structural budget deficits (and are, or will soon be, running surpluses), and will experience zero or negative inflation and lower interest rates as their currencies continue to rise against the dollar. Hence they can readily adopt new expansionary measures, of the proper types and perhaps limited to a temporary period, without risk of renewed inflation.[4]

Fourth, a new multilateral trade negotiation should be launched as soon as possible. The history of trade policy shows that forward momentum toward trade liberalization, along with equilibrium exchange rates and effective domestic adjustment programs, is an essential component of any successful strategy to resist protectionism. Such a strategy is essential because any resort to widespread protectionism (such as a US import surcharge) could trigger extensive retaliation, disrupt the entire world trading system (and hence the world economy) and detonate the Third World debt bomb. In addition, new trade liberalization can contribute to the targeted increase in world growth.[5]

[4] Marris, Deficits and the Dollar: The World Economy at Risk, especially Chapters 6-7.

[5] Gary Clyde Hufbauer and Jeffrey J. Schott, Trading for

Fifth, improvements are needed in the functioning of the international monetary system. At a minimum, reform is needed to avoid huge currency misalignments a la 1981-1985 (and in earlier episodes since the adoption of flexible exchange rates). More ambitiously, an effective monetary system could help foster more internationally consistent, and hence sustainable, economic policies in the major countries--perhaps discouraging the adoption of such opposite, and ultimately incompatible, mixes as those adopted by the United States and other major OECD countries in the early 1980s. The most promising approach is to establish "target zones" for the key currencies, which would accurately reflect underlying competitive positions within ranges of 15-20 percent, and might induce the major countries to consider the external ramifications of their internal decisions much more systematically. Credible establishment of such a regime would reduce business uncertainties, promoting higher levels of investment and growth as well as preempting the protectionist pressures which inevitably follow large currency imbalances.[6]

Sixth, the "Baker plan" to increase external capital flows to the major debtor developing countries by about $10 billion annually needs to be implemented fully, and probably expanded.[7] Conditions are ripe for renewed growth in some of

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Growth: The Next Round of Trade Negotiations, Washington: Institute for International Economics, September 1985.

[6] John Williamson, The Exchange Rate System, Washington: Institute for International Economics, revised June 1985.

[7] Donald R. Lessard and John Williamson, Financial Intermediation Beyond the Debt Crisis, Washington: Institute for International Economics, September 1985.

the key LDCs, if the external financial constraint can be alleviated. Conversely, insistence on further austerity could jeopardize the entire debt strategy and thus the world economy as a whole. The expanded exposure asked of the commercial banks is quite modest (2 1/2-3 percent per year), and the World Bank can readily expand its lending without any tap on government budgets.

The different components of this six-part strategy have different time dimensions. Some measures, such as easier monetary policy in the United States and perhaps fiscal expansion in Europe and Japan, can be adopted rather quickly. Some, such as completion of the currency realignment (and hence scope for monetary ease abroad) and mobilization of funding for the Baker plan, may require several months to a year. Some, such as the needed fiscal tightening here and reform of the monetary system and completion of a new trade "round," will take several years.

All of the recommended steps, however, can be launched promptly even if their full implementation will take some time. Indeed, their adoption as a policy package by the major countries together could have substantially favorable effects on global confidence, thus immediately spurring higher growth even before all elements were totally in place.

Such a package would be a natural outcome from the Tokyo summit in early May. It could be prepared during the spring in the OECD (on growth, fiscal policies and interest rates), the Interim Committee (on Third World debt and monetary reform) and the GATT (on trade negotiations). I recommend that the Committee seek to promote such developments, in the interest of restoring world growth to a more acceptable level and of regaining international competitiveness for American industry.

THE US TRADE BALANCE, CURRENT ACCOUNT, AND FOREIGN DEBT: 1984--1990

(in millions of dollars, with exchange rates
as of January 15, 1986)

	1984	1985e	1986p	1987p	1988p	1989p	1990p
Exports	220	245	275	300	335	365	400
Imports	-327	-360	-400	-430	-475	-520	-570
Trade balance[a]	-107	-115	-125	-130	-140	-155	-170
Net interest payments	5	0	-15	-25	-35	-50	-70
Current account[b]	-102	-120	-135	-150	-170	-200	-230
Net foreign debt (at end of year)	29	-90	-225	-375	-545	-745	-975

Source: Stephen Marris, Deficits and the Dollar: The World Economy at Risk (Washington: Institute for International Economics, December 1985), Table 3.2, updated to exchange rates of January 15, 1986--the dollar at 202.38 yen, 2.46 DM, 1.41 Canadian dollar, etc.

e = estimated
p = projected

a/ Balance-of-payments basis.
b/ Includes other services items, not shown separately.

C. Fred Bergsten
Director
Institute for
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January 17, 1986

PRESENTATION OF JERRY J. JASINOWSKI

Mr. **Jasinowski**. Thank you very much, Paul, and thank you, Mr. Chairman, for the invitation, as well as friends and distinguished guests here in the audience many of whom have been my colleagues in the past. I think I peaked, Mr. Chairman, in my duties at the Joint Economic Committee and certainly I peaked in terms of many of the close friendships and relationships that I was able to have on the committee.

Let me just try to get a little closer to the microphone itself. As I said, thank you, Mr. Chairman and others, for letting me speak to you today and it's always a pleasure to be on a panel with Fred Bergsten.

In the letter that you sent Mr. Chairman, you suggested that the United States faces the double challenge of "creating an expanding and stable world economy and creating economic institutions in this country which can compete effectively in such an open world economy." That is, indeed, it seems to me the challenge and I have tried in the prepared paper to lay out some of the policies that I think are necessary to do that, many of which Fred has talked to already, with exchange rates obviously being at the center of those policies. What I would like to do in the time I have today, rather than referring to those specific policy measures, is more to emphasize what I think is an attitude, a philosophy, an overall point of view with respect to the issue of international competitiveness.

A friend of mine a few days ago told me that there's a new book out on anecdotes. I could probably give you an even more livelier talk if I had had a chance to read the book, but I'm told that Calvin Coolidge, our 30th President, is prominently displayed and contained in the book. It is an oddity that "Silent Cal" reportedly saved from utter dullness only by a lively and quick wife—which I might say is true for more of us than we would like to admit—should be so honored.

The Coolidge anecdote I learned first has to do with the description of how his wife asked him about what happened in church one morning when she was unable to attend. Grace: "What happened in church?" Cal: "Oh, the usual, there was a sermon." Grace: "Yes, I know, but what was it about?" Calvin: "Sin." Grace: "What did he say about it?" Calvin: "He was against it." [Laughter.]

I'm sure some of you have heard the story before, but I think it has a parallel in part to the current trade debate and reflects the kind of rhetoric I think has come from business leaders, Members of Congress and others. Let me briefly summarize.

Protectionism, we are against it. Exports, we are for them. Fair trade, we want it. Free trade, we don't believe in it.

It would be amusing—and I'm sure this symposium will make a difference in correcting that dilemma—if this collection of attitudes that I've just given you were not cited at a time when we badly need a consensus on trade policy in this Nation.

We have no policy consensus with respect to trade. We have no true trade policy in this country. This is not meant to be a criticism of the administration or Congress. Clearly, the President and Secretary Baldrige and many members of Congress have been addressing this issue, and with respect to the current changes or recent changes in actions with respect to the exchange rate I think credit should be given.

My point is that we are still a very long way from a consensus about the problem, what it means to American life, about the policy changes that ought to be made in order to address that problem, and that consensus it seems to me is as much a political question as it is an economic question.

I would argue, as Fred has, that we need a consensus very badly because of the erosion of competitiveness in this country. I have included a chart in the longer talk which looks at the U.S. share of world exports and imports from 1960 to 1984, and what you find on that chart is a movement as a share of world exports from 18 percent in 1960 to 11 percent in 1984, whereas if one were to look at the import side you see a movement from 12 percent in 1960 to 18 percent in 1984, almost a perfect reversal of the relative roles of exports and imports in our trade accounts over this period.

Now I could go into other numbers that you have heard and I will not, to indicate the extent to which the trade problem is a major issue, in fact with respect to manufacturers in many cases a crisis. I think the more important thing is to ask ourselves: Given these deficits, what policy conclusion does one draw from deficits of this size? And I think the first policy conclusion is that they are not sustainable and will not be sustainable over the next several years. They will come down either because of adjustments in the exchange rate itself or they will come down for other reasons having to do with changes in policy.

But in my view—and I think the country as a whole has awakened to this fact—we will not tolerate trade deficits as high as $69 billion in 1983, $123 billion in 1984, and an estimated $142 billion in 1985.

Now how we approach this problem I think depends on how we analyze it and here I want to share with you a concern that has to do with our inability to seem to come to grips with a consensus on what ought to be done about the trade deficit. This is fresh in my mind because I have just returned from Harvard University where I attended the Advanced Management Program there which is a program for senior executives from around the world studying the competitiveness of the firm.

As you might imagine, a great deal of the course was devoted to the issue of national competitiveness and what troubled me is that in that debate there was a tendency for analytical views about the importance of macropolicy or micropolicy to end up as armed camps and ideological positions which alternately stated that either it's all a macroproblem or, conversely, the real problem is the long-term erosion of competitiveness and what we need is in fact to have microintervention in the economy in order to make our firm more competitive.

This dichotomy it seems to me is a mistake, and what I would argue is that although it's fine to have these intellectual camps, the business we ought to be about here at the Joint Economic Committee, in Congress, and in the business community is to recognize that these two camps are not mutually exclusive, that a competitive strategy requires action on the macrofront as well as action on the firm front as well as action with respect to microeconomics.

Therefore, what we should be concerned about at this point is developing again a consensus on a competitive strategy overall.

I would be remiss, Mr. Chairman, not to mention the fine work that has been done by the Young Commission with respect to just that, and the fact that a great many of the problems as well as recommended solutions have been laid out in that fine document which has really not gotten attention from the White House or the Congress to the extent that it deserves. I think it provides some of the bases for the consensus on trade competitiveness that I think is essential to the country overall.

Now let me turn from the question of the need for a consensus to say a few more things about what I think is what the business community is looking for with respect to trade policy in a consensual sense.

If the problem is serious and we need to act, it seems to me important for us to look for a clear and well-reasoned goal. In the 1960's when I was educated in economics, Paul Samuelson's textbook argued that it was important for us to have a balance-of-trade surplus or he may have said just a balance in our international accounts, but he certainly put the emphasis on the need to have a balance in order to meet our international obligations abroad. I think most of us accepted that.

I would argue at this point in time, even though I think it's bold in some repects and others might say naive, that we really need to consider a trade surplus as our overall international goal and that that trade surplus should come not through protectionism and not through closing our doors but through competitiveness.

If I were to pick a slogan, it would be "A trade surplus through competitiveness." Now again, when you're where we are today, one could say I am naive to suggest that we move so far in the other direction, but I think that part of the problem is in fact because we have not set goals and we have not come to recognize the need to compete on a worldwide basis that in fact the policy does not follow, and if we could find a consensus within the business community, the Congress and the administration on this or on some other goal which would move us in that direction, I think it would be very important.

It's important to note that that means dealing with manufacturing because of the $142 billion trade deficit that we will have in 1985, about three-quarters of it is in fact in manufacturing. So this trade deficit that we are talking about is not an oil trade deficit. It is a manufacturing trade deficit and it is not a trade deficit that will go away given the picture that we see in the current account.

Now I implied by what I said about the goal that it is important for us to make a new commitment really for the first time to international competitiveness. I was struck in my time at Harvard at the extent to which other countries are committed and believe and care about being competitive in the world economy. In this country we are only now waking up to the problems and issues involved in international competitiveness, and here the question of attitudes is as important as specific policies. This question of attitudes has to do with corporations and labor as well as Government with respect to all the things that are necessary to change our way of thinking about how we compete in the world economy.

Some of the other measures that are important with respect to fulfilling that commitment fall into both the public and private sector. Let me just say a word about the private sector because I think too often the private sector simply comes to town to say what Government should do in this area when in fact as much of the problem, Mr. Chairman, is in fact in our corporations and in our employment practices as much as it is here in Washington, at least on a longer-term basis. Therefore, the place to begin correcting our competitiveness problem is with NAM members within corporations so that we will be competitive on a world class basis.

I guess I'm not as sanguine as you are, Fred, that there are not long-term problems here. I think that there are some long-term structural problems and beyond that, although corporations have moved I think heroically to cut costs, to improve quality, to change the way they deal with their employees, to implement computer and information management systems, to look at a whole new restructuring arrangement from factory locations to how they manage inventories, the fact of the matter is, a substantial number of our corporations are still not competitive on a world class basis.

I believe that we're moving in that direction in manufacturing and I believe that American manufacturing leaders are committed to achieving that worldwide competitiveness.

But if we do that, we need to move just as much on the macro side to deal with the issues of exchange rates that Fred has already correctly emphasized as the major public policy problem to deal with the question of the reductions in the Federal deficit that are related to that and to deal with the problems with the House tax reform bill which I think will harm competitiveness. These macro issues need to be addressed and they need to be addressed soon.

At the same time, there are a host of across-industry, institutional and trade policy issues that should complement those and they run from the creation of a trade department to organized trade on a first-class, worldwide, competitive basis—the issues having to do with export disincentives, the way we shoot ourselves in the foot with respect to export control policies which the Young Commission has estimated cost this country about $12 billion and here, Fred, you talked earlier about trade barriers which I think should be dealt with with emphasis too. It's only $8 billion, but $8 billion here and $8 billion there and $12 billion somewhere else and pretty soon it adds up to a lot of money. So I guess I'm here to give you what will appear as a parochial point of view in some respects—that is to say, the point of view of American manufacturers—and if that's so, I'm sorry because that's not what my intention was. My intention is to say that we need to operate both in the private sector and among the various views of the trade problem to come to a national consensus, and that this national consensus will have to be based in large part on strengthening our business institutions.

I warned you that I was going to quote Calvin Coolidge again. Among his more famous utterances which you all remember is that, "The business of America is business." That has over the years fallen into substantial disrepute and there's certainly no need to glorify business and all the things that it does in this country given its awards as other institutions have. But I think other countries do not view business entrepreneurship and the production enterprise as something which has to be apologized for and I think it's essential that as we look at this trade competitiveness issue that we look at it in terms of recognizing that the production of goods and services is absolutely crucial to dealing with the competitiveness issue.

I would say in fact that the discussion on trade and the discussion on competitiveness from the point of view of the economics profession has put too much emphasis on consumer welfare. We all know how wonderful it is to improve the marginal utility of consumers by increasing the amount that they possess, but I would say that we have in recent years been on a consumer spending binge, as Walter Heller said last night, financing it with tax cuts in this country and imports from abroad. And although it may feel good, over the long term we will not have a place in the world which is commensurate with what we have had in the past and we will not be able to be fully competitive if we don't begin to think more about the importance of what we produce, how well we produce it, how good the quality is, and how we sell it, and what kind of excellance we bring to the question of production, which is the responsibility of business in the first instance; but it is the responsibility of Government then in a partnership to address it too. I would hope, Mr. Chairman, and other distinguished guests and speakers, that we would try to do that in the context of developing a consensus on how to be competitive on a worldwide basis.

Thank you very much.

[Applause.]

[The complete presentation of Mr. Jasinowski follows:]

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HALFTIME REASSESSMENT

An Industry Perspective on Politics,
Trade, and the American Economy

by

JERRY J. JASINOWSKI
Executive Vice President and Chief Economist
National Association of Manufacturers

at the

Joint Economic Committee Symposium
in Honor of the 40th Anniversery of the Employment Act of 1946

Washington, DC
January 17, 1986

Mr. Chairman, Members of the Committee, distinguished guests, ladies and gentlemen, as a former member of the staff of the Joint Economic Committee, it is a special privilege for me to have been asked to participate in this celebration of the 40th Anniversary of the Employment Act of 1946. Since its creation by that Act, the Joint Economic Committee has consistently provided critical economic guidance to the Congress and to the country. It is to be congratulated for that effort and encouraged and helped to continue with it.

Even in such a small matter as the letter of invitation to this seminar, I think you, Mr. Chairman, have identified the issues we should be focusing on. You suggested that we in the United States face the double challenge of "creating an expanding and stable world economy, and creating economic institutions in this country which can compete effectively in such an open world economy." Indeed that is the challenge.

A friend of mine told me a few days ago that there is a new book out which is a compilation of anecdotes about famous people. Regrettably I haven't seen it yet. I could probably give you a livelier talk if I had, but I was intrigued to hear that Calvin Coolidge, our 30th president, is one of those about whom there seem to be a wealth of anecdotes. It is an oddity that silent

Cal, reportedly saved from utter dullness only by a lively and quick wife, should be so honored. The Coolidge anecdote I learned first has to do with a description to his wife, Grace, of a morning at church that she was forced to miss. Reportedly Grace asked him what happened.

Calvin: "Oh, the usual, there was a sermon."
Grace: "Yes, I know, but what was it about."
Calvin: "Sin."
Grace: "And what did he say about it."
Calvin: "He was against it."

I relate that because it makes it easier for me to quote Mr. Coolidge again a later, and because I think one could sum up the almost endless stream of commentary on international trade in the last year with equally mystifying terseness.

There is hardly a Congressman or Senator or top business executive who has not made a speech on international trade in the last year. Just as there are those who would preach the redemptive value of sin, there are exceptions to the following summary of the current outpouring of opinion on trade, but, by and large, it is correct for both business and Congress:

Protectionism--we are against it.

Exports--we are for them.

Fair trade--we want it.

Free trade--we don't believe in it.

The trouble with this collection of attitudes is that it does not add up to a trade policy when we desperately need one. This is not meant as a criticism of the Administration or the Congress. Clearly the President, Secretary Baldrige, Ambassador Yeutter and others have goals and are doing some very important things in trade policy and in other areas, namely exchange rate policy, where the payoff in trade is potentially enormous. My point is that we are still a long way from a national consensus on the importance of international trade to our economy and for our national life. In today's world of instant communication and massive trade flows, a world in which over 70 percent of all U.S. products face foreign rivals here or abroad, that is an unacceptable handicap. The lack of such a consensus, in my view, threatens to undermine the benefits America derives from its position as the world's premier trading nation, the largest exporter and the largest importer.

Traditionally, it has been American exporters--principally the Fortune 500 companies and the agricultural community--who have been the mainstays of the open international trading system. I think I run little risk of challenge when I say that neither of these groups is as wedded to the undiluted doctrine of free trade as they once were. This is not to say that anyone underestimates the importance of exports to the U.S. economy.

Exports account for roughly one in five American manufacturing jobs and one out of every three acres of agricultural production. But, as you also know, U.S. exports are not what they were just a few years ago. In the last four years, we have suffered setbacks in virtually every manufacturing export sector, from power generating equipment to office machinery to aircraft, and our 1985 exports, though better than 1984, were still not up to U.S. performance in 1981. This is certainly not a criticism of American exporters. With a dollar that has been sixty percent overvalued against the world's other major currencies, it is a tribute to U.S. exporters that they have been able to export at all.

The fact remains that we have seen an enormous erosion in U.S. competitiveness. I have included in the printed version of this talk a Commerce Department chart that makes this point dramatically. The chart shows what happened to U.S. exports as a share of the world market in the period between 1960 and 1984 and what happened to the U.S. import share of the world market in the same period. The contrast could not be more striking. Our export share was 18 percent in 1960 and is now down to around 11 percent. Our import share, then about 12.5 percent, has soared and is now almost 18 percent.

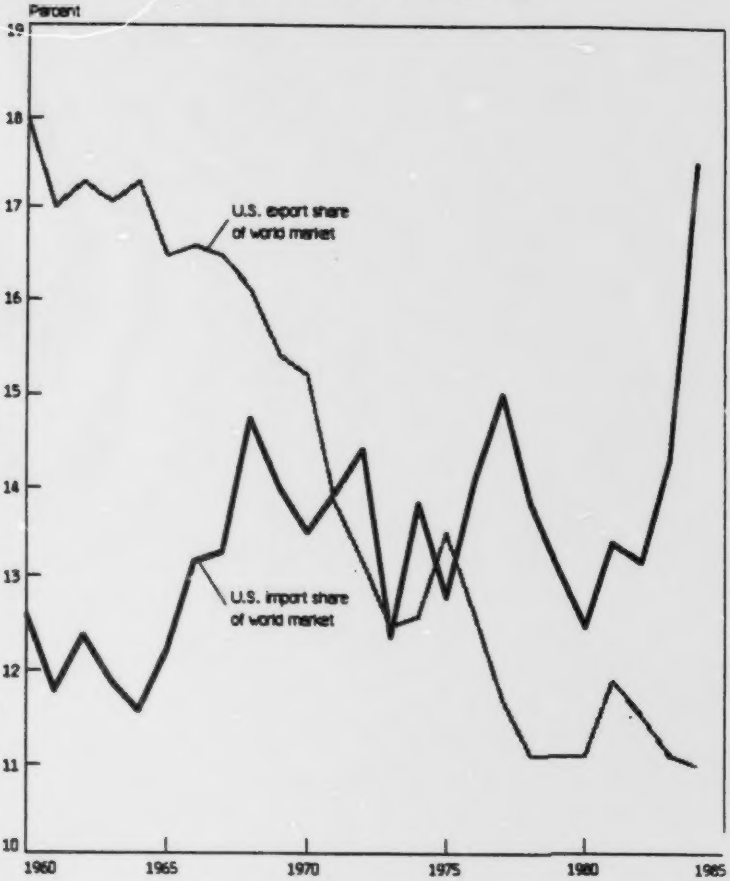
The trade policy conclusion one draws from all of this is that gains from imports, significant as they may be, seem an insufficient justification for sustaining the huge trade deficits that we have had for the past several years: $69 billion in 1983, $123 billion in 1984 and now more than $142 billion in 1985. Trade deficits of that order cannot and will not be sustained much longer.

That is the first and most positive meaning of the outpouring of rhetoric on trade. There is now a realization by political leaders that something has gone seriously wrong in our international accounts and in international trade. Actions will be taken. Sooner or later the trade balance will come down, though we know that is not likely to happen this year or next. And sooner or later we will see corrections in the now unsustainably large current account deficit. Our economic future depends not simply on whether we tackle these problems--we will tackle them--but on how. Our actions in turn depend upon how we analyze the trade problem.

Before launching into a comment on how one might look at the problem, let me first share with you a worry. From what I know of U.S. history, including the history made by those who wrote the

2.18

FIGURE 2.0
U.S. Share of World Exports and Imports: 1960–84



SOURCE: International Trade Administration.

Employment Act of 1946, I am as impressed as one can be by the ability of the United States to solve difficult problems, problems that at first seemed impossible. I am equally impressed by our propensity to create such problems. Having only recently returned from a semester in the Advanced Management Program at the Harvard Business School, which I enjoyed a great deal, I have the feeling that many of our difficulties relate to the tendency to turn analytical tools into ideological camps.

I saw this quite clearly at the Business School. There is an academic faction that is wholly convinced that the root of our economic problems is only the past mismanagement of macroeconomic policy. Proponents of this school argue that if it cannot be done with monetary and fiscal policy it shouldn't be done. Certainly, there should not be any interference with the movement of goods and services across international boundaries. Tnere are of course a hundred corollaries to this position. They include the notion that fiscal policy should be limited to areas where its use will not unduly influence the character of the U.S. economy, and the belief that if we keep our eye on the objective of expanding the world economy, U.S. competitiveness will take care of itself.

The alternative view is that essentially all economies are mixed economies and that governments cannot avoid responsibility to use a wider array of tools or the need to make some normative judgements about what the structure of the U.S. economy should be. Advocates of this position read that famous line from Proverbs--"Where there is no vision, the people perish."--as an injunction to try to encourage not only the fact but the character of economic growth. The lights of this school would argue that, while it may not be necessary for government to pick winners, it is necessary to encourage winners.

My concern is not that there are these two intellectual camps but they seem to regard their ideas as mutually exclusive. I believe policy must draw from both.

I will return to that point, but first I think I should be clear that this debate is not confined to academic institutions. Discussions in the NAM, certainly those in NAM's International Trade Policy Committee, often break down along just these lines. Yet there are some interesting differences, and they too are illuminating. Let me give you an example.

Over the last two or three years, NAM has been the site of numerous discussions of the problem of industrial targeting abroad. By targeting I mean the conscious, governmental nurturing of particular industries, often with the goal of making them dominant, world class competitors. As you know, important cases involving

Japanese targeting have been filed with the Office of the U.S. Trade Representative. Those we have looked at most closely involved machine tools and semiconductors.

Our views on these issues have not been a matter of instant consensus. Some NAM companies have argued that to act against Japan in these matters, especially where there is no clear defense for the U.S. action under the GATT, would not be in the U.S. interest. They stress that our economic problems are not going to be solved or even helped by discrete trade policy actions. Meaningful change, they say, can only come through macroeconomic adjustments, such budget deficit reduction and improvements in the exchange rate system. Companies that hold this view often make the additional point that a U.S. antitargeting action would be a stone thrown from a glass house. In this connection they cite the several American industries, from airplanes to agriculture, that owe much of their success to the active role that the U.S. government has played in their development.

The counterargument comes from those who feel their debt to Uncle Sam is less. They say in effect, why should we, who have not benefitted from subsidies, be denied the ability to defend ourselves from foreign competitors that have so benefitted? The irony I hope I have succeeded in showing is that it is frequently the beneficiaries of interventionist, microeconomic governmental initiatives, often through the Department of Defense, that in trade terms are the most strongly opposed to industry specific actions. My purpose, however, is not to declare any faction right or wrong. But I will make a plea for pragmatically seeking a consensus from these two camps.

THE PROBLEM

An effort to find a consensus means that we begin our assessment of the problem--not with statements about what tools we will use to solve it--but with a description of the problem itself. For convenience sake, let us simply say that the problem is the trade deficit. The United States is rapidly on its way to becoming the world's largest debter. We were its largest creditor just a few years ago. That is a fact we are not only going to have to live with but, hopefully, change. Much of that change is going to have to come through an improvement in the trade account.

Let's take last year's trade deficit--call it $142 billion--and ask, how is it different from the deficits we have been running with only a couple of exceptions since 1971. There are three major differences. The first and perhaps most important is that this one, like the 1984 deficit, is primarily a deficit in manufactures. The difference between our imports and exports of manufactured goods this year will be about $109 billion in red ink. That is equal to more than three-quarters of the total deficit. It is important to state here that one cannot improve the U.S. trade balance without dramatically improving our trade performance--our trade competitiveness--in manufacturers, which make up nearly about 70 percent of our exports.

A second characteristic of today's trade deficit is that it is associated with an alarming deterioration in the U.S. current account. The 1984 current account deficit was $102 billion, and '85's promises to be much larger. For a while it was possible to argue, and many did, that mounting merchandise trade deficits were acceptable because they were offset by earnings from services and returns on U.S. investment abroad. As I have indicated, America's excess of imports over exports is being financed to a great extent by borrowing from abroad. We have gone on a shopping spree with foreign money.

The third big difference in the trade deficit today is that it has put trade in the national political spotlight. That is an important change, because it provides an opportunity to reverse the trade deficit.

GOAL: A POSITIVE TRADE BALANCE

In the 1960s, when the United States still had strong surpluses in its international accounts, Paul Samuelson's famous textbook argued that it was necessary for us to have them to pay for our array of commitments abroad. Speaking personally, I would suggest that a trade surplus is today not an inappropriate goal for the United States. If I were to reduce that idea to a slogan, it would be "A Trade Surplus Through Trade Competitiveness." The phrasing is important because this is one goal whose achievement would be painfully hollow if it came about through any other means. So phrased, however, the idea should not be as controversial or as threatening as I know it will seem to some. After all, few would quarrel with the notion that United States and U.S. producers need to be more competitive. Arguably, the other side of the slogan is just a tautology. If we are competitive in a broad range of manufactured goods, we will have a trade surplus.

What policies, what institutions, what attitudes does a trade surplus through trade competitiveness imply? Above all it implies a broad political commitment to competitiveness, commitment by government, by industry, and by the American people. The last is not just a rhetorical flourish. The evidence is everywhere that citizens in other trading nations are fully committed to international competitiveness. We delude ourselves if we think we can solve our trade problem without the same kind of commitment from the American people.

THE SOLUTION

The "how to" part of striving for a trade surplus is more difficult. Policies and medicines share the characteristic of having undesirable side efects, and in most cases, there is a direct correlation between the strength of the "cure" and the seriousness of the unwanted extra consequences. We are lucky in this sense: we have been doing enough things wrong over the course of the last ten years that we can get sizeable benefits by simply doing things right.

Corporations

The place to begin correcting mistakes is within American corporations, i.e., NAM members. Much of our loss in competitiveness has its origins in management errors, make no mistake about it, and it is management's responsibility to get its own house in order. Fortunately, I can report that business leaders, in industry after industry, have been making dramatic changes in order to become more competitive. Today's corporate leaders, for the most part, are:

- aware that they must compete on a global basis;
- cutting unnecessary cost at every level of the enterprise, from the inventories carried to the number of people in staff functions;

- implementing quality programs in the production process so that productivity and value added are increased;
- applying computers and information technology to everything from materials handling and production to the delivery of products and services;
- using technololgy to create new products and services that are more responsive to the consumer;
- developing employee programs that encourage worker participation in improving the firm's competitiveness; and
- restructuring corporations themselves so that they become more flexibile and more competitive.

These actions already show important gains, but it would be a mistake to claim that all, or even most, American corporations are truly competitive on a world-wide basis. But I believe it is the deep commitment of industry leaders to achieve that goal.

The Budget Deficit

The budget deficit hangs over the U.S. economy like a vulture. It drives up interest rates, slows and distorts domestic economic growth, pushes the current account deficit further into the red as it increases our obligations to foreign lenders, and exacerbates the trade deficit through its effect on the dollar. NAM sees

Gramm-Rudman-Hollings as an important step toward bringing discipline to the budget process.

But let's be serious about just how far we can go in reducing the budget deficit when 65-70 percent of the budget is exempt from cuts. The answer is not far enough. Social security and defense have to be on the table too.

Taxes

We also need to avoid mistakes with respect to tax policy. One reason, for example, that the President had the embarrassing hiccup he did in the first House vote on the tax bill is that so many Republican representatives believe that the current tax reform package (H.R. 3838) can only hurt U.S. competitiveness. They are right. We do not need and cannot afford that kind of change in our tax laws. Aware that the debate over tax policy is just as certain a feature of the political landscape as are death and taxes themselves, I would add this: If we reach a point where it is necessary to raise taxes it should be done in a way that helps our international competitiveness. A broad-based transactions tax would meet that test.

Trade Organization

In government, the problem we face is much more one of attitude than structure. But that is not to say we could not be better served by a better structure. The agencies of macroeconomic policy are well enough known, but what is the agency responsible for implementing U.S. commercial policy? Is it the U.S. Trade Representative's Office, a White House office? Is it the Commerce Department? Our trade task would be easier if the answer were clear: It is the U.S. Department of International Trade and Industry, an idea NAM has long supported.

TRADE POLICY

What are some of the trade policies that could complement these domestic macroeconomic and institutional measures? People who have been writing and talking about trade have been articulating many of the same ideas year in and year out for the last five years at least. In general, they are low cost solutions, and they are the ones we should try first. And a consensus is beginning to form around many of these ideas. Let me run through them quickly.

Exchange Rates

The largest component of the trade problem is that the exchange rate system has simply not been working in recent years. The exchange rates that have linked the dollar, the Japanese yen, the German mark and other currencies have not reflected the major developments in those economies or the realities of trade flows. When the Japanese are piling up trade surpluses and the United

States, trade deficits, the yen should rise and the dollar should fall. Yet until very recently the picture has been just the opposite.

The Plaza Hotel meeting of the Group of Five major currency countries on September 22, 1985, was a good first start. And we have seen significant adjustments in exchange rates since that meeting. It was only a beginning, however, which is why so many of the trade bills awaiting Congress's return set out one means or another of coaxing the U.S. government towards efforts to achieve a more institutionalized reform of the floating system.

Export Disincentives

We also need to stop shooting ourselves in the foot on trade. We have always had the tasks of making other countries in the world, other people on the block, aware of how we feel about certain political issues while at the same time selling them our goods. When the technique of making them aware is not selling to them, we clearly can't do both. Too often in the past we have opted for not selling, through export controls, and we have paid dearly. The President's Commission on Industrial Competitiveness, published last January, calculated that the United States loses more than $12 billion in lost sales each year through our export control policies. Those policies needed to be seriously restricted.

Foreign Corrupt Practices Act

Similarly, we need to reconsider the Foreign Corrupt Practices Act, which has effectively frightened many U.S. companies out of valuable foreign markets. We do not have to abondon its purpose, but we do have to redesign that law so that its adverse effect on U.S. commerce is lessened.

EximBank

The Export-Import Bank has a significance far beyond the sums spent to keep it going. U.S. exporters lose sales every day because they cannot compete with the credit terms that foreign rivals are able to offer with the help of their official export credit agencies. Only a small portion of U.S. exports are supported by official credits, about 5 percent. In Japan, the U.K., and France, official credits support between 25 percent and 40 percent. Even so, year after year, as the trade deficit mounts, U.S. exporters find themselves in a losing battle to defend Exim against further cuts. One should not need to point out that the exports Exim does support are vital. What perhaps does need to be emphasized is that Exim has become something of a barometer for government's interest in trade competitiveness. If our challenge is to build a national consensus for trade competitiveness, it is essential that we ensure a stronger EximBank.

Foreign Trade Barriers.

We also need to reduce foreign trade barriers. Thanks to the Tariff and Trade Act of 1984, we now have a USTR report that sets out for everyone to see many of the most serious foreign barriers to U.S. exports. The next step is convincing our trading partners of our determination to see those barriers come down. The Administration's recent self-initiation of both 301 cases and an important dumping case shows evidence of a new and welcome toughness on the part of the White House. Enactment of some of the more helpful ideas in the omnibus trade bills should help to ensure that that attitude becomes a permanent feature of U.S. policy.

GATT Negotiations

Then there is the issue of improving the world trading system. Virtually everyone who has thought about the problem agrees on two aspects of the GATT multilateral trading system. There is agreement that, as the only international system we have, it is important to save it if we can. There is also broad agreement in the United States that the GATT's deficiencies are such that it cannot continue as a force in international commerce if they are not corrected. Shared views on those two points have led more than half the Senate to sponsor legislation authorizing a new round of GATT negotiations. Industry too is broadly supportive of those negotiations, but for both Congress and U.S. manufacturers the real proof will be in the pudding.

We very much hope that our trading partners will be willing to accept new international discipline over targeting, over the use of camouflaged safeguard measures, and over trade distorting investment policies. The United States has an obligation to pursue these ends, which our government is doing, but we also have an obligation to consider how we are going to respond to situations that demonstrate the absence of effective agreements in those and other areas. Several legislative proposals appear to address these questions.

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I warned you I was going to quote Calvin Coolidge again. Among his more famous utterances was the observation that, "The business of America is business." Statements like that have for some time been made in America only with a certain hesitant defensiveness. I doubt that the Japanese, Koreans, or Germans experience the same diffidence with regarding the importance of business. And we can no longer afford to. The business of America is business.

And business is creativity. It is making things. It is job creating and product innovating. These are not small points. Traditional economic analysis can be properly faulted for its over emphasis on consumer welfare, its emphasis on the importance of posessing rather than creating. The competition in the industrialized world is not so much over who gets to own the products of late 20th Century industry--who isn't surrounded by semiconductors? It is over who gets to make them. And in that competition we have to be a winner.

I rather whimsically entitled this speech HALFTIME REASSESSMENT. The football analogy is useful. If you think of the game starting after the Second World War, we were the clear winners at the end of the first quarter. That was foreordained by the outcome of the war itself. As I indicated earlier however things turned against us in the second quarter, which one can think of as lasting from the mid-sixties to the present.

In this analogy it is now halftime, and we need to turn the game around. Our decline in international competitiveness has forced a crisis in our international accounts. The question we are now wrestling with is whether and how we will forge a national consensus to reverse that decline.

Mr. Chairman, I can think of no more worthwhile endeavor for the Joint Economic Committee than helping Congress and the nation reach a consensus on competitiveness.

Thank you.

Senator Sarbanes. We have time for just a few questions and I will recognize them. If you could speak loudly we won't have to repeat the question.

A Voice From Audience. I have a question for the two speakers. Mr. Jasinowski was talking about getting a national consensus. I'd like to see if we could get a consensus between the two speakers. Mr. Bergsten was saying we should get the exchange rate down to about the 1980 level or something like that, everything would be fine. Mr. Jasinowski says that wouldn't be enough. We've got to do all kinds of other things. That's one part of my question.

The other part is, he goes so far as to say it's not only to get the trade balance down where we don't have a deficit but that we get a surplus. I imagine they disagree on that.

Can we have a discussion between the two speakers?

Senator Sarbanes. Who wants to go first?

Mr. Bergsten. Let's err on the side of overkill and do both. I'm fully supportive of what Jerry advocated in terms of American business improving its competitiveness. I went out of my way to say carefully in my remarks that we should do everything we can to get our savings rate up and our deficit rate down and quantitative barriers down. I made an analytical judgment that that would not solve much of the trade deficit problem, but let's do both.

A Voice From Audience. If I might follow up on that, about the overkill. That is, the idea of getting more than a trade surplus and what impact that would have on very critical countries and the problem they have in servicing their debt.

Mr. Jasinowski. I think the target of the trade surplus is bold and I throw it out really to hear from my colleagues as to what they think, but I think that it is that kind of a reversal in our thinking about this problem that's necessary to come to grips with it.

Mr. Bergsten. One word on that. I have some agreement with Jerry. As my table shows, the United States having now become a net debtor country, we're going to have a big deficit in our current account. We're going to have to get our current account into balance and a merchandise trade surplus or else we will be like Brazil, running a trade deficit and borrowing the money and paying interest on our existing debt. So on that I'm on Jerry's side as well.

A Voice From Audience. This is a very complicated and multifaceted problem. We've talked about macro versus micro. I recall that following World War II with the Marshall plan one of the measures that we encouraged in Europe was the establishment of productivity councils.

Now since our interest rates are all undergoing deficits in their trade balances, I would pose the idea of establishing labor-management councils in our different industrial sectors that would exchange information and develop approaches for technological improvement in order to get down to the microeconomic level of this problem.

I wonder if there are any reactions to this?

Mr. Jasinowski. Well, I think that a substantial number of businessmen have always been concerned about entering into that because it takes us down a road which some think is a compromise. My own view is that that idea is changing and increasingly in management circles and employee participation is welcome at all levels and I see no reason why councils at an industry level would not be useful.

Now you do get into the question if you go the European route and describe the goals and all that—I think that's very problematical, but if you want to get into discussions about how to make an industry more competitive, the industry level is the place to do it.

I think that the point I was trying to make was really in the context of an anecdote which I think misses the value of thinking of business in its key role as a production element of society. Now there may be more glorification of business today in terms of images of people driving around in limousines and all kinds of other things, but I don't think this society has really yet recognized the extent to which the production side operation is absolutely critical to its long-term economic health. Business leaders haven't recognized that as much as they should and certainly consumers haven't. That's the point I'm trying to make. I'm trying to make the point about the value of being more competitive on the production side.

A VOICE FROM AUDIENCE. I'd like to have a follow up on that very point on how to increase the competitiveness of American business without paying some more attention perhaps to the wrokers who are the main part of the consumers.

Mr. JASINOWSKI. I don't think you can in fact, and I would say that individuals as human beings are the principal ways in which we will be competitive worldwide and I think it's a whole revolution that's going on in management circles that have come to the conclusion that investments of people, participation by people, the commitment of people, is more important than any other single thing. So I think that the antagonism between management and workers is on the decline.

A VOICE FROM AUDIENCE. If I may just push a point that I hear implicitly in all these questions, without denying the importance of the seriousness of the international trade problem and the balance-of-payments difficulties which we have gotten ourselves into, to come in here and say that you want a consensus and then to present the problem in a way which does not recognize any of the other economic and social problems of the country seems to me to pose it in a way in which it's impossible to get a consensus. That is, it doesn't seem like you have presented a very balanced picture of the views which have to be considered in combination with the trade deficit in order for the country to realistically get itself together to face what is undeniably a serious problem.

Mr. JASINOWSKI. Well, I think that's a fair point and I said that I didn't want to make a parochial talk for my part, and Fred can speak for himself, but you can't cover the Moon and the Sun and I don't know how I would answer some of those questions anyway.

I think your point is correct. You can't get a consensus very easily without other things going on, but let's start trying to get a trade consensus and see where that takes us.

Mr. BERGSTEN. You certainly can't cover the whole universe in 15 minutes, but the things that I advocated to promote our international position I would also advocate for improving our purely domestic conditions—low interest rates, more competitiveness through higher savings and investment rate, and the like. It doesn't address every ill of the country, but no single scheme is going to do that, and I don't see how any part of my program was inconsistent with broad economic and social objectives.

A **Voice From Audience.** I wanted to ask you a question this way. Is the deficit we have in trade really a function of avoiding a Third World default where we generated our energy and borrow in the Third World and South America economies to forestall a real problem and we've taken the risk that your charts show just to get out of that gamble that we took 3 or 4 years ago?

Mr. **Bergsten.** The simple answer is "No." A small percentage of the U.S. trade deterioration was our contribution to put it that way to the reduction in external imbalances of the third world through which they began to adjust to their external debt problem and therefore avoid problems for our own lenders. But that was a very small share, less than 20 percent, of the overall deterioration of the U.S. external balance.

I think it is true, as implied by the first question, that as the United States now looks to improve its external account by something between $100 and $150 billion over the next few years, even without going to surplus, we have to try to minimize the extent to which that falls on the debtor countries and recreate that crisis. That means our Japanese friends are going to have to take a big part in the adjustment and our European friends are going to have to take a big part in the adjustment and so is Canada.

The distribution to the rest of the world of the U.S. improvement is perhaps the biggest international issue in the next 5 years and we're going to want to minimize additional problems that may cause, particularly in the Third World.

Senator **Sarbanes.** We're going to have now to bring this session to a close. We will be resuming immediately in the Cannon Caucus Room with the afternoon panel. I want to thank Fred and Jerry for their presentations.

[Applause.]

[Recess.]

AFTERNOON SESSION

Chairman **Obey.** We have two panels remaining before the symposium is closed. Before I introduce the panel, I wanted to just note two people in the audience, Mr. Roy Blough, who served on the Council of Economic Advisers from 1950 to 1952; and I know he was out there. I just saw him a moment ago unless he moved. And Janet Norwood, Commissioner for the Bureau of Labor Statistics.

The panel which we will begin with this afternoon is to address the question of meeting the challenge of international competition.

Undoubtedly, the most important economic development over the last 50 years or 40 years has been the globalization of our entire economy. Today American workers and firms face increasingly sophisticated competition and many firms have themselves have become major foreign producers, reducing what we've often thought of as our national comparative advantage.

This internationalization has perhaps fundamentally undermined past economic as well as political orthodoxy, and it's created new highly complex challenges for American public policy.

Historical trade deficits recently have dramatically illustrated that we are not now adequately meeting this new challenge of international competition. We certainly were told that by our two speakers at lunch just a few moments ago. Jobs and markets lost to foreign producers will not be easily regained. Massive foreign borrowing to pay for our trade deficits have caused the United States to become a debtor nation last year for the first time since we emerged from the status of a developing nation in 1914.

We have now raced past Brazil in accumulating obligation and have become the world's largest debtor. Current trends cannot be sustained and we face the question of what kinds of actions must be taken in order to meet the challenge.

How do we deal with the problem? What are the realities that we must confront? Should we organize ourselves differently to deal with the problem and, if so, how? How much of the problem requires macroeconomic thinking and adjustments and how much is micro?

For today's moderator for the panel we have Jerry Cahill, a veteran reporter of the New York Daily News, whose specialty is the economic beat.

PANEL: MEETING THE CHALLENGE OF INTERNATIONAL COMPETITION—JERRY CAHILL, MODERATOR

Mr. CAHILL. Thank you, Mr. Obey.

Welcome to the global village. When I was starting out in this business as a cub reporter 30 years ago in Wisconsin, not too many miles away from Wausau, which is Dave Obey's stomping ground, folks didn't worry too much about things like trade or multinational corporations. We all know that the situation today is vastly different. We are awash with foreign imports; and it's not just Japanese cars, television sets, and electronic gadgets, or French wines or Italian shoes.

The other day my wife brought home a half pint of fresh raspberries for which she paid a dollar less than the price of the same size half pint of California homegrown raspberries. The difference was, her bargain priced raspberries came from Chile.

In other words, the global village has really arrived.

Each member of our panel this afternoon brings a unique perspective I think to this discussion topic. Howard Samuel, on the far left, is president of the industrial union department of the AFL-CIO. He's been in the trenches where the battle of foreign competition has taken its heaviest casualties, in the factory towns of America. Mr. Samuel is president of the IUD of the AFL-CIO. He's also served as Deputy Under Secretary of Labor for International Programs. He was a member of the President's Commission on Industrial Competitiveness.

Next to him is Mr. Ray Vernon of the Harvard Business School. Mr. Vernon is an expert on multinational corporations which, some would say, have inflicted some of the heaviest casualties in this battle.

Next to Mr. Vernon is Kevin Phillips, a widely read, widely respected political analyst. He has some thought provoking ideas on what can be done to redress the trade imbalance. Mr. Kevin Phillips is president of the American Political Research Corp. He is a contributing columnist to the Christian Science Monitor, a regular contributor to the Los Angeles Times, the New York Times, and the Washington Post.

And finally, Mr. Lionel Olmer, on my left, former Under Secretary of Commerce for International Trade. Mr. Olmer is a member of the law firm of Paul, Weiss, Rifkin, Wharton & Garrison. He formerly served as director of international programs for Motorola, Inc. He will be the first speaker to deliver an overview of the problem.

Before he begins however, I would like to remind the audience that if you have questions, simply raise your hand and members of the staff will be there to pick up your written questions and bring them to the front.

PRESENTATION OF LIONEL H. OLMER

Mr. OLMER. Thank you, Jerry.

Ladies and gentlemen, I am deeply honored by having received an invitation to appear before you today and to attempt to convey some thoughts which may be relevant to the discussion which has been the subject of this distinguished committee for the last 2 days. But I am also struck by the fact that, not being an economist, I am not going to have a formula of precise measurement which I can leave with you, nor give you any degree of assurance that a reduction in our trade deficit or an increase in our international competitiveness is likely.

Indeed, I would like to provide you in this overview with what I believe to be the important implications of the trade deficit on the United States industrial base and to suggest some steps which might be taken and which hopefully might lead to an amelioration of a condition which I now believe to be approaching an extreme condition for our manufacturing sector.

We have seen an unprecedented movement offshore of much of American basic and high technology manufacturing as a consequence of an inability to compete from the United States. Many companies which have had a long history of great success in exporting from America have abandoned such strategies. Companies which can be competitive from the United States have become reliant to an extraordinary degree on foreign components for their products.

I learned of an example just the day before yesterday that even the very vaunted, and I think justifiably so, sector of our economy that produces in limited volume, but of unparalleled competence, supercomputers, is dependent on a Far Eastern manufacturer of components in order to assemble its final product. Without these components it could not—could not—produce that final product. So even in supercomputers, we are dependent on imported semiconductors.

Manufacturing employment in this country has remained either stagnant or is declining. There is an accelerating sale of technology from the United States as an alternative to the provision of U.S. hardware and services. That is, companies struggling to stay competitive are reduced to selling technology.

There is, in my judgment, a serious loss of industrial preparedness for mobilization. That is, we are not prepared to meet some of our responsibilities from our industrial base in the event of a mobilization requirement.

Now the causes are many and varied. Many of them have already in the last year become conventional wisdom: the strong dollar; weaker growth in the developing world; a growing debt problem in the less developed part of the world; closed markets in some countries, a loss of competitiveness on the part of American companies that have failed to invest in modernization, in new plant and equipment; and a work force that in some areas, in some pockets of industrial America has lost the virtue of hard work and efficiency.

It seems to me important to point out to the audience—and Fred Bergsten touched upon it at the end of his luncheon remarks—that increasingly it is important for us to post a surplus in the merchandise trade account and it's important because everyone agrees that eventually we are going to have to reduce our status as a net debtor nation. We are going to have to bring our debt down. And in order to bring it down, we will have to post some surpluses.

So one needs to look at the range of possibilities. Can it come from agriculture? I think not. We will be very lucky to retain the increasingly small surplus in agriculture that we have enjoyed the last couple of years. Can it come from services? Again, I think not. And so by the process of elimination, we are left with the necessity of posting a surplus in the merchandise trade account.

"Will we be able to do it" is the $64 question, and it strikes me that much of industrial America has either given up the ghost and left our shores or reversed its strategies, so that it is arguable that even with a vastly reduced dollar value it will be extremely difficult to recapture that international competitiveness.

Remember that foreign companies have not stood idly by and markets which have been lost by American companies will not easily be regained regardless of the value of the dollar. Customer relationships have been built up, long-term supplier-consumer ties have developed in these past 5 years.

So one question in my mind is whether or not a weak dollar can reverse the deficit and, in my view, the answer is no. The dollar had appreciated only 20 percent relative to the yen in the course of the last 5 years and I don't believe there would be any informed person who would suggest that the roughly 20 percent depreciation of the dollar in the last few months is going to result in any serious, significant diminution in our deficit with the Japanese.

The dollar only appreciated 6 percent against the Canadian dollar and we have a roughly $20 billion or more deficit with Canada. The ASEAN countries tend to track the value of their currencies with the dollar and indeed import prices have risen since 1980, not declined.

So what are we going to do? The answer lies not in a single step but in a multitude of steps, and I believe that the administration is on the right track and I'm delighted to learn that Fred Bergsten and Jerry Jasinowski agree that it is a first step. Thank you.

[The complete presentation of Mr. Olmer follows:]

The U.S. Trade Deficit and U.S. Manufacturing: Causes, Effects and Cures

December 31, 1985

LIONEL H. OLMER
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The staggering trade deficit which the United States continues to accumulate (it should reach more than $140 billion for 1985) has rippled through the U.S. economy like a fierce summer storm. But, unlike a hurricane, the consequences of the trade picture will batter the American industrial landscape for many years to come.

There has been a $117 billion swing in the trade account of manufactured goods between 1980-1985: from a $13 billion surplus to a $104 billion deficit. The volume of exports of manufactures was roughly 15% less in 1984 than it was in 1981; and, although the value of manufactured exports last year was 8% higher than in 1981, fully 40% of this increase was the result of defense-related procurement. Total imports of manufactures grew by 53%, and, despite the recent decline in the value of the dollar, there are no indications whatsoever that the deluge of foreign imports will subside appreciably at any point in the near future.

The short and long-term effects of this situation are many and varied; from the perspective of most manufacturers, particularly small and medium sized businesses, they are almost always painful. While larger corporations have also been hard-hit, often they have had the resources with which to adjust. There are indications, however, that the sustaining nature of the trade deficit is forcing even the "giants" to adopt new means of doing business in order to remain profitable. Unfortunately, the new approaches add up to a seriously diminished national capacity to manufacture.

"Globalization" is an old term given new meaning in the context of corporations developing strategies to accommodate tougher foreign competition and an overvalued dollar:

-- Major elements of manufacturing have been moving offshore at an accelerating rate.

-- Investment by U.S. companies in their foreign affiliates has expanded fourfold over investment in domestic activities in the past year.

-- Domestic manufacturers are increasing their reliance on foreign components.[1/]

-- Employment in manufacturing in the U.S. has remained stagnant at roughly 1979 levels, and hundreds of thousands of workers have been displaced from factories which no longer produce automobiles, textiles, steel, or footwear.

[1/] An agreement reached last year between Japan and the U.S. to end tariffs on semiconductors and computer parts, although heralded as a major achievement on behalf of free trade, was in fact stimulated within the U.S. private sector by companies more desirous of eliminating duties on what they import from both Japan and elsewhere in Asia rather than on what they export. The savings in duties on imported parts is expected to

(Continued)

-- In relative terms, job losses in the U.S. have also been substantial across a wide range of value-added products such as cameras, televisions, consumer electronics, telephones, copying equipment, and, more recently, in many high technology areas as well.

-- When new equipment is purchased to improve productivity in the factory, it has often been of foreign, not of U.S., origin.

-- It is not unusual to find companies with a long history of exporting, giving up foreign markets or serving those markets from offshore facilities.

-- Finally, as alternatives to U.S.-led exports, some companies have turned to licensing their technology in lieu of selling their products, or to joint ventures and mergers with foreign partners as the only practical means of remaining profitable.

Are these phenomena due mainly to the strong dollar or to unfair trade? Are they a function primarily of slow

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(Continued)

exceed the duties on exports from the U.S. by a factor of at least ten to one.

economic growth abroad and thus relatively less demand for U.S. goods; or to a loss of markets in Latin America because of its debt problems; or have American companies lost the will and the ability to compete?

Virtually everyone in and out of government seems to agree that all of these factors have contributed to the trade deficit and are thus forcing a fundamental restructuring of America's economic base. There remains serious disagreement, however, on the relative weight of each factor and, more importantly, on whether this reshaping process is inherently harmful. Some argue that it is beneficial -- a sort of "creative destruction," which in the end will forge a more vibrant America out of the transient discomfort of industrial adjustment.

The optimistic prognosis holds that the world is becoming more economically interdependent; that American society is increasingly dominated by the development, distribution and consumption of information and that most of the jobs it will ever need can be generated by the vast and unlimited services sector rather than from the smokestack industries whose time has passed.

Still others have argued that a large U.S. trade deficit was a boon not only to the international economy (i.e., that America must serve as the engine of world growth), but also that the deficit held inflation in check during the economic expansion in 1983-84. That is, when the American economy was growing at 8% annually, it was a good thing that the trade deficit lopped off what would have been 2% additional growth. But with the economy growing at a sluggish 3% annual rate, the loss of 2% growth becomes not a boon but a burden.

• But there are many reasons why sustained trade and current account deficits (the latter being a broader measure of the international exchange of goods and services) are inordinately unhealthy and why they merit strong measures by government to reverse their upward movement:

- The current account deficit for 1985 of about $125 billion is nearly twice as much a percentage of U.S. gross national product as it had been in the country's entire 210 year history (3 percent now, heading to 4 percent -- some would say 5 percent within a few years -- while the previous high was 2 percent in the 1870's during an unprecedented industrial and railway expansion boom). Financing such enormous deficits means international financial markets will be flooded with U.S. dollar assets, threatening higher interest rates to keep foreign investment coming into America, and risking, ultimately, a loss of confidence in the U.S. economy.

- To bring down the deficit it will be essential that the U.S. experience a sizeable surplus in manufactures trade, simply because a surplus from any other source isn't likely: the U.S. will of necessity remain dependent on importing various raw materials and petroleum (which has equaled roughly half of the trade deficit); it cannot expect a significant increase in the surplus of agriculture exports (the existing surplus is by no means assured); and growing interest payments on America's foreign debt is eroding its position as a net exporter of services.

Thus, the responsibility for lowering the deficit will fall necessarily on manufacturers.

At the very time when it is urgent that the U.S. experience a surplus in manufacturing exports, it may be that much of its industrial base, having left America's shores or having abandoned export strategies, is no longer able to compete in international markets. Moreover, during periods of slack demand, much less during a recession, U.S. companies will be hard pressed to retain their existing markets, much less recapture what they have lost to foreign suppliers, many of whom have invested heavily in developing strong and lasting relationships with their U.S. customers.

The United States, the leader of the world community, must maintain a strong industrial base which is capable of responding on short notice to a call for mobilization of its defense structure. This is not to say that it must -- at whatever cost -- maintain the ability to produce "everything" needed in whatever the mobilization scenario; that is impossible, clearly. Yet, U.S. government officials must remain sensitive to what is happening to the industrial structure as a result of trade and economic policies which have been pursued sometimes without consideration of their national security implications. The list of "essential" industries could get temptingly large, even out of control if restrained only by the strength of the political constituency involved. It would thereby represent an open invitation to full-scale protectionism for the sake only of sustaining a domestic presence which otherwise would not be viable. Such a result would be highly undesirable . . . but the risk to Western security of a "hands-off" policy is far greater.

Evidence of the executive branch's agreement that the problem is a serious one is reflected in the Administration's intense effort to engage the leading industrial nations in a multi-part, cooperative program is designed to:

(1) bring down the value of the dollar (and, thereby, increase the international competitiveness of American products);

(2) cause other leading industrial democracies to stimulate their economies (and, thereby, increase their demand for goods, including from the U.S.)

(3) encourage commercial banks to extend new loans to the debt-ridden nations in the developing world;

(4) aggressively pursue the further opening of foreign markets for U.S. goods and strictly apply trade laws to prevent unfair competition from injuring U.S. companies.

But, the higher the deficit becomes, the greater will be the burden on the manufacturing sector to post a surplus and this means that even greater pressures will be placed on each of the four parts of this program.

The consensus on Capitol Hill also seems to be that the situation is reaching something close to desperate proportions. Unfortunately, this perception is too often accompanied by a belief that the deficit is, in largest measure, the result of the wily trading tactics of our allies, mostly the Japanese, who use a combination of government and financial assistance, protected home markets, and lower wage and capital costs, to dispatch their American competitors to second class status. And so, months of frustrating debate have led to several versions of a trade bill designed to legislate "an even playing field" in order to deal "effectively" with the Japanese.

Would that it were so simple!

It is misleading at best to imply any substantial connection between all of the real and imagined unfair trading practices of the major trading nations, and the size of the U.S. trade deficit. If all the markets in the world were open on an equitable and balanced basis, and no nations were permitted to sell products at prices below fair value or with the benefit of government subsidies, it would merely dent -- by less than 10% over several years -- the $140-150 billion trade deficit; it certainly would not immobilize its negative movement.

In attempting to analyze causes, one startling statistic reveals the significance of the value of the dollar to the trade balance: in 1979 U.S. labor costs were 25 percent lower than those in the Federal Republic of Germany; in 1984 they were 25 percent higher. And, while labor costs in the U.S. were never lower than those in Japan, they climbed to two thirds of U.S. labor rates in 1978 and remained roughly at that level until recently when, because of the strong dollar, they fell again to one half those in the U.S. Individual companies are extremely hard-pressed to overcome such competitive disadvantages, even in businesses which are more capital than labor intensive.

But the strength of the dollar, although very significant, perhaps even the most important cause, is still only one among several important factors.

It is vital that policymakers not focus on this or any other single cause; rather, it is essential that they remain keenly attentive to the mix of contributory factors so as to design a mix of solutions. For example, since no more than 5-8% of the U.S. trade deficit should be attributed to unfair trade practices, it make little sense to "retaliate" indiscriminately against Japan or East Asian NICs and risk the loss of valuable markets for U.S. farm, aerospace, power generation, office equipment and other high technology products.

Unfortunately, it also appears that the lowered value of the dollar at the level experienced over the last four months will not of itself do very much in the near future to the size of the U.S. trade deficit. For when the trade account is disaggregated, a number of revelations appear which, taken together, diminish greatly the prospect that a moderately lower dollar (meaning 20% less than its 1985 high) can have more than a moderate effect on the trade deficit:

-- 25% of U.S. imports of manufactures originate in Japan, but the dollar appreciated less than 20% against the yen between 1980-85.

-- 20% of total U.S. imports of manufactures enter from Canada, yet the U.S. dollar appreciated only about 6% against the Canadian dollar between 1980-85.

- 16% of U.S. imports of manufactures are shipped from the East Asian NICs, and their currencies are essentially "pegged" to the U.S. dollar so that changes in the latter are generally matched by adjustments to the former.
- Although the dollar appreciated by a staggering 73% average with respect to the French franc, West German deutch mark and British pound, imports from these countries increased only about half as much.
- Import prices since 1980 have not been lowered as might be expected with a strong dollar, but, rather, they have actually risen slightly, indicating wider profit margins on foreign products and therefore an ability of exporters to cut prices along with a declining dollar.

So, if it isn't an elimination of unfair trade practices, nor a sustained reduction in the value of the dollar, how about loss of markets in the developing world, especially Latin America?

Indeed, roughly 40% of the deterioration in the U.S. manufactures' deficit between 1980-84 was due to export surpluses of developing countries and the loss of markets in Latin America.

Yet, Brazil, Mexico and other Latin American economies simply must post export surpluses in order to pay interest owed on accumulated debts. And these favorable trade balances cannot be maintained only by government-imposed cutbacks on imports, as was the case during 1983-84. Imports, especially of essentials to the manufacturing process, are necessary to stimulate economic growth. Any further restraint on growth would threaten social instability in certain countries in the developing world -- and it would obviously mean a continuing loss of market opportunities for U.S. exporters.

There is not a simple "yes" or "no" answer to the question as to whether U.S. companies have "lost" the ability to compete internationally, even absent the exchange rate phenomena of recent years which has reduced so dramatically their price competitiveness. Evidence abounds of industries which have failed to modernize, which turn out products lacking in quality and reliability, or which have allowed runaway costs far in excess of efficiency improvements. Yet, it is instructive to note the sharp upturn in U.S. productivity growth of the last five years and observe that for the first time in the post World War II era, it has equalled that of Western Europe.

Largely due to efficiency improvements and new investment in manufacturing equipment, output per worker in the U.S. increased twice as fast from 1979-84 as it did between 1973-79.

Still, U.S. productivity growth lags far behind that of Japan and in the largest single source of America's trade deficit with that country, the automobile sector, it is unlikely to catch up in the near term. Analysis suggests that despite the $80 billion investment by Detroit in retooling and in research and development over the last several years, Japanese manufacturers have maintained at least a $2,000 per car cost advantage over comparable U.S. motor vehicles. In 1986, Japanese (and Korean) motor vehicle manufacturers will increase their market share in the U.S. by a substantial percentage. Direct investment within the U.S. by foreign producers will also be accelerated but not nearly fast enough to offset perhaps as much as an additional $8-10 billion of trade deficit in this sector's account.

Nevertheless, there are many industrial goods produced in the U.S. that are fully competitive internationally, or which would be, except for the strong dollar. One could say with some optimism that a substantial segment of American industry is poised for a comeback; as the value of the dollar declines, as economic growth rebounds elsewhere, as the pressures to open markets succeeds, as commercial bank lending to Latin America resumes, these companies will be prepared and capable of exporting.

The answer to the U.S. trade deficit is that there is not single, adequate policy response to the accumulated imbalance and its affects on U.S. manufacturing. It will be necessary to "fix" a number of things which haven't worked or which are acknowledged without argument to be unsatisfactory.

Stamping out unfair trade practices; opening markets; beginning a new multinational round of trade talks next year to improve existing rules and to establish new rules for trade in services, stimulating economic growth so as to create increased demand for U.S. goods, bringing down the value of the U.S. dollar so as to make these goods more competitive; pressing Japan to do more to reduce its surplus; encouraging commercial banks to renew lending to Latin America and, finally, reducing the U.S. federal budget deficit, are all manifestations of legitimate concern. They cannot be criticized . . . except by those who wonder whether these measures -- even collectively -- will be enough. If they are not sufficient, or if only of limited success, those in the U.S. who have been committed to the pursuit of free trade may be convinced -- or forced -- by stark circumstances to turn elsewhere for solutions.

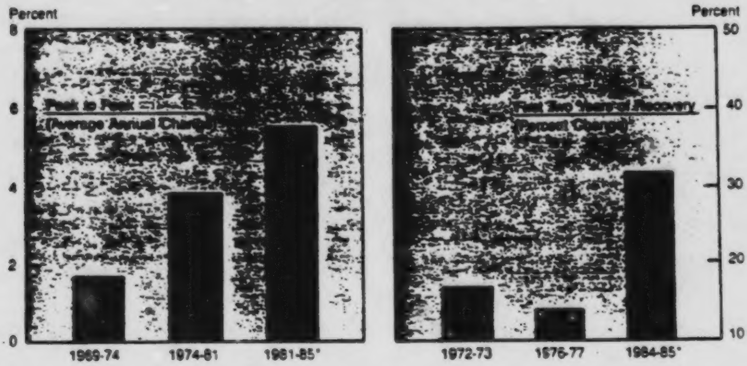
The Administration is taking the right tack in its comprehensive approach; will our trading partners do their share?

Most importantly, if the Administration's answers are inadequate, or if the Western democracies do not cooperate, American industry will find itself in a hole so deep that subsequent government intervention to salvage its badly damaged remnants may take the form of highly protectionist (and politically irresistible) trade legislation. And this would be neither in America's interests nor the world's.

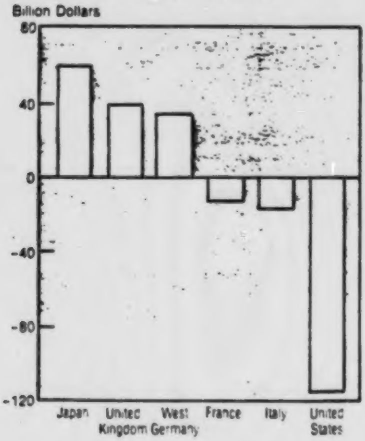
This year, 1986, might well prove to be a watershed . . . for the international trading system as well as for America's domestic industrial structure.

Figure 3

REAL GROWTH IN U.S. INVESTMENT IN MANUFACTURING DURING PAST THREE BUSINESS CYCLES

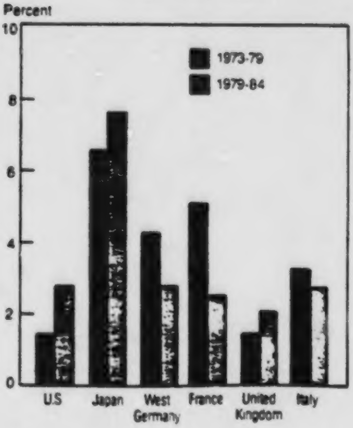


INDUSTRIAL COUNTRIES: CUMULATIVE CURRENT ACCOUNT POSITION, 1981-1984*



INDUSTRIAL COUNTRIES: TRENDS IN MANUFACTURING PRODUCTIVITY, 1973-84*

Average Annual Change



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Changes in Manufactures Trade Flows and Real Exchange Rates

	Percent Change, 1980-84		
	U.S. Mfrs. Exports	U.S. Mfrs. Imports	Dollar Appreciation (real)
Japan	32.4	83.7	19.5
Canada	37.9	76.3	6.4
United Kingdom	- 1.7	31.3	69.6
West Germany	- 10.1	43.7	76.0
France	- 15.8	54.7	73.9
East Asian NICs	22.9	109.3	19.8
Mexico	- 22.3	87.1	28.4
Brazil	- 46.7	208.8	1.8

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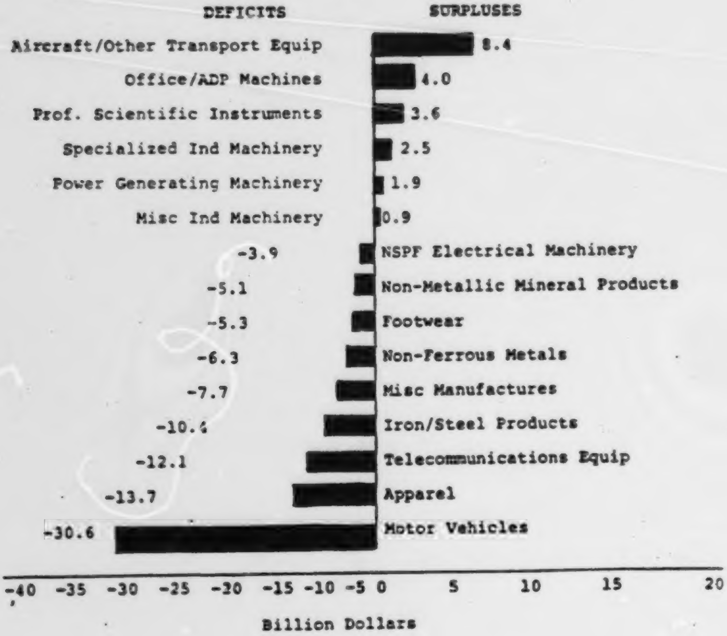
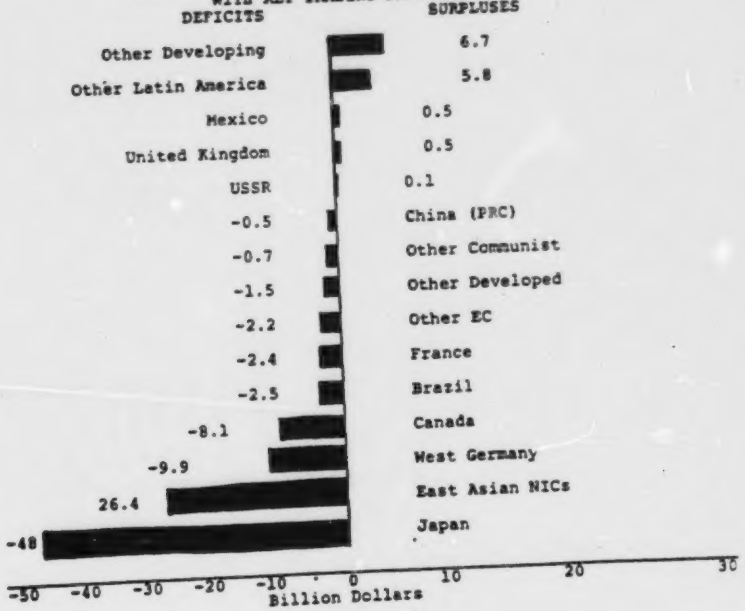
*1981-1984.

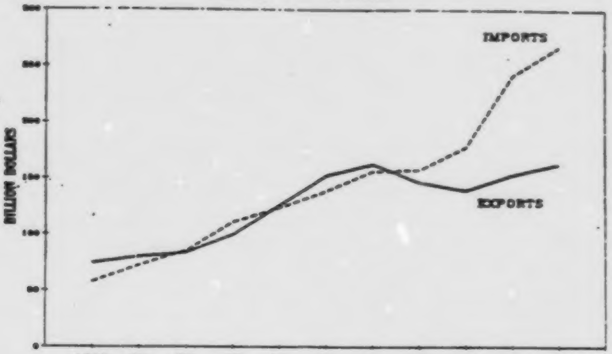
1984 U.S. MANUFACTURES TRADE BALANCES
BY COMMODITY GROUPS*



1984 U.S. MANUFACTURES TRADE BALANCES
WITH KEY TRADING PARTNERS

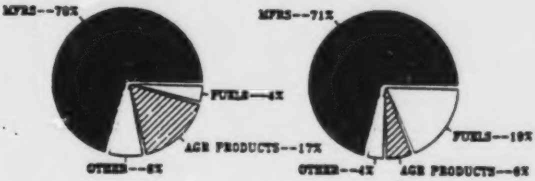


U.S. MANUFACTURES TRADE
1975 – 1985*



*1985 IS FIRST-HALF AT AN ANNUAL RATE.

COMPOSITION OF U.S. MERCHANDISE TRADE
1984



EXPORTS
$217.9 BILLION

IMPORTS
$341.2 BILLION

Mr. **Cahill**. Thank you, Mr. Olmer.

Mr. Phillips, tell us how to solve the problem.

PRESENTATION OF KEVIN PHILLIPS

Mr. **Phillips**. Well, Lionel Olmer has preempted my remarks that I'm not an economist so I don't have the solution. So let me say that as a political analyst, what I'm going to try to do is structure a somewhat different context.

The trouble is with so many economists is that they come in and talk about competitiveness circumstances in a largely or wholly economic perspective, and they have notions of Zen management or algebraic equation economics which does have the benefit of not being readable by any policymakers who could seriously rate its prospect of success.

What I want to try to raise is a context in which we try to think about economic policy in a political framework, not a partisan political framework but a global political and historical framework. For example, if we knew right here today that the world was moving into what could be called a neomercantilist era and moving out of a free trade pattern, it would obviously have a terrific bearing on what would be a plausible set of U.S. policies and what would not be.

Conversely, of course, if we could apply political analysis and come to the conclusion that we were really moving into a free trade era and that Japan was going to pick up where the United States and Britain have left of by picking up the banner of free trade, and that the other little dragons of East Asia would, too, we would come to a different set of economical-political conclusions.

However, I think it's pretty conclusive when you start getting into the politics of it that we're not simply in a global economic renewal, but to some extent we're in a global political economic realinement where a loss of economic leverage is putting the United States increasingly behind the eight ball and outmoding institutions in the United States. I would say that perceptions in the United States that we're still on top are out of date, and that instrumentalities created 40 years ago in the heyday of U.S. power, be they the United Nations, the World Court, the General Agreement on Trade and Tariffs, or what have you, are also increasingly outmoded. We need to examine and recognize this by pursuing a cohesive look at the strategic historical evolution of post-1945 U.S. circumstances.

And I think that it's time that we come to grip with this change and while I think the administration has begun to move in some of the correct directions, I think it's been a very belated move, as of course a number of people in the administration privately agree. Nor has it gone far enough yet.

I'm going to very briefly go to the idea that there are three things that we need to do, a threefold strategy. But before I do, I want to touch on a little bit of historical context.

Arguably, the global upheaval that we're in now in terms of the changes in the economy and the political economic relationships is roughly akin to that which prevailed during the reformation and the rise of capitalism in the 16th century and then during the industrial revolution in the 19th century.

Now if that's a fair analogy, and I think it is, when you had all sorts of shifts in who produced what and for how much, and regional and international economic relationships were in a total upheaval, what you saw as that developed during both of those previous eras was a lot of political uncertainty and rising nationalism. John Naisbitt talks about "high-tech, high-touch." Well, I would say high-tech, low politics.

What happens is, as people get uncertain about what's happening in the economy, about the way things are changing, they reach out for familiar cultural patterns. One is religion—today's fundamentalist trend from Iran to Lynchburg, VA—and the second is economic nationalism, which is obviously powerful around the world these days. We're seeing "wagon-circling" political economics: circle the wagons to protect what's developing and to get more, and circle the wagons to protect what's established and threatened.

If this is a fair analogy, it raises enormous problems for the United States. The first problem is for a country like ours with a belief in manifest destiny. There is no time limit on manifest destiny, apparently. The President still assures it today. In part, that's because there's not all that much awareness of global currents in the United States in contrast to Belgium, say, where your typical Flemish farmer can probably tell you the rates of five currencies within one decimal point. But if you go out to Kansas City and ask what the dollar is, compared to the French franc, you don't get much reaction. We are not a country that thinks that way.

We will have to, though. Competitiveness is an issue which is simply not going to be in the economic future for a number of years, but also in the political future. It's systemic, and not simply a transient result of the confluence of trade pressures with an overvalued dollar.

Some of the most fascinating statistics in this particular dimension involve comparing the circumstances of the United States with those of the United Kingdom in the late 19th century and early 20th century when Britain's global economic hegemony was in the process of winding down. Britain really launched free trade, and at the time of the repeal of the Corn Laws in 1846, they had 50 percent, roughly, of global manufactures. By the time they were down to 25 percent of global manufactures, or roughly thereabouts, in the late 19th century, large parts of British industry were moving toward protection. By World War I and thereafter when their share was even lower, the protectionist pressure in Britain grew fierce. They finally went protectionist in 1933, passing the tariff act then.

There's a similarity in the United States, if you trace the way we've started to move toward protectionism. We were staunchly free trade in 1945 as the British were a century earlier and, of course, that lasted for more than 20 years, but as our share of global manufactures has wound down there are problems in steel and problems in textiles and in automobiles and rubber and what have you. The same political currents that roiled Britain in the 1890's and the early 1900's, and then consummated around the depression, are at work here, and it's not coincidence. It's just a change in the whole economic circumstance of the United States.

And I think that what that brings us to is the need for three basic changes in U.S. economic policy or economic awareness. I'll just go through these very quickly.

The first is that we have to think strategically. With all these changing patterns in the world and changing involvements of Government and trade and economics, it's not enough just to say, hey, let's rely on the marketplace and wave everybody's Adam Smith tie. That doesn't work any more. Government is too much of a factor, and too many parts of America will be disadvantaged by ignoring the roles of foreign governments. But mostly what we have to do is, as I say, think strategically and try to coordinate policies, and I'll come back to this in a minute.

The second part is that we've got to really come up with a pretty sweeping agenda of commitment to the competitiveness crisis. It's not just a question of trade law, it's also a question of tax law, of export finance, of antitrust law, of research and development, of education, of protection of intellectual property and so on. And it will be important to pull it together.

The last point before I flush them out a bit is the question of tax policy. It's just increasingly apparent that we have to have some form of tax increase in the coming year for budget reasons but we also need to reform tax policy for international competitiveness reasons and there's nobody who has been more forthright or persuasive on this than the Chairman of the Senate Finance Committee, Bob Packwood of Oregon, and it's to be hoped that his views on this particular question are important in the coming tax reform deliberations.

But the question of strategy is important—to build on that for a second—because the administration has had this terrific commitment to the free market. Just let the free market operate, whether that means your textile industries are being drowned or your farm exports are being priced out of the market by the overvalued dollar or what have you, and well, the free market does a good job.

The trouble is that the administration, feeling that way, hasn't tried to coordinate dollar policies with trade policies, hasn't tried to coordinate tax policies with international competitiveness strategies. Now, of course, they are finally starting to. Things have changed for the good since September, as Lionel Olmer pointed out, and as many others have. It's a good thing. But there's still not all that much strategy there.

There is still not an effective instrumentality for coordinating trade-related economic policies, and we need that.

We also need, I think, a specific, across-the-board administration commitment to 10 or 12 policy areas where they are going to try to knit it together and make competitiveness awareness something that Americans can see held up as, for example, the Germans held up competitiveness with England in the 1890's and early 1900's. We need a handle so that Americans can see a crisis and react to it and rally around the policies necessary, not least because this competitiveness crisis could be a catalyst for the sort of sacrifice which may be necessary on the deficit front.

And the last point about the policies that are I think mandated by this crisis has to do with a consumption tax. I think the politics of the crisis, in trade, budget and tax, will all knit together in the need of the system to come up with new revenues and to do so in a way that reacts to all of these crises. And a consumption tax, something like the European value-added tax or whatever, which would be border-neutral, would be something which would start to adjust our system to international competitiveness questions. The Japanese are thinking about a VAT too, and if they move in that direction the pressure becomes even greater. A consumption tax could lubricate tax reform and would raise money for deficit reduction.

So I think all of these ingredients—the idea of strategizing, the need for a bold competitiveness agenda to catalyze public opinion, and the utility of a consumption tax to move on three important economic aspects—tax reform, the deficit, and trade competitiveness—is critical.

[The complete presentation of Mr. Phillips follows:]

Meeting the Challenge of International Competition:
America's Need for a Competitiveness Strategy

by Kevin Phillips

The subject of international competition has become a pressing one in the United States of late, and deservedly so. But much of the speculation is one-dimensional, basing remedies and solutions entirely on principles of economics and management theory.

This is inadequate. The argument can be made -- and I will certainly make it here -- that U.S. policymakers also have to keep politics and political economy in mind. I'm not talking about U.S. partisan politics, Republican or Democrat, but about the relevance of changing global political circumstances and currents to the future of U.S. trade, trade policy and international economic strategy. For example, if we knew that the world was turning back towards mercantilism, we'd be wise to pursue different policies than if we knew that a new free trade era and mechanism was just over the horizon.

To be sure, those are extreme choices. We're not very likely to be able to "know" either option as a safe trend on which to operate. However, it is possible to look at world trade and the world economy over the last decade or so and see a definite pattern of 1)increasing direct and indirect participation in trade by government; and 2)increasing resort by nations to *neo*-protectionism -- subsidies,tax breaks, administrative and regulatory devices et al -- in lieu of the tariffs of yesteryear; and 3) increasing speculation that the helpful or apathetic role of a nation's government may now be a factor, along with purely economic assets or circumstances, in what economists call a country's "comparative advantage."

These measurements and judgements are as much a matter of politics as economics -- and in some cases, politicians may be better able to face these apparent trends than economists unwilling to abandon obsolescent theory. At any rate, a *political* analysis of the changing global competitiveness context suggests that the United States is now and has been for at least 5-10 years caught up in a global realignment of who produces what and for how much. We're winning in some categories, but we seem to be losing in a *greater* number -- and that includes some of the high tech industries most important to America's future. Basic economic shifts are central, of course. But other factors are also involved. For example, one supporting reason for this ebb is the difficulty Americans have had in giving up our post-World War Two nonchalance about trade matters and their importance. They didn't use to count; now they're vital. Another reason, which I'll come back to, is that we've been relying on world organizations set up in our heyday right after World War Two -- organizations from the United Nations and UNESCO to the World Court and GATT, the General Agreement of Trade and Tariffs. They don't work for us so well now because they reflect the new realities of global power relationships in the 1980s. We may not be able to change that. Finally, this new global competitiveness context raises the possibility that the United States cannot afford to remain the only major economic power without a trade department, without a border neutral tax system (able to tax imports and rebate for exports) and without serious governmental mechanisms for coordinating U.S. international economic policy.

At a minimun, the changes taking shape would seem to require the U.S. government to begin thinking strategically. That's particularily true of senior Executive

Branch officials. Indeed, few needs will be so compelling over the next few years -- and few omissions have been so detrimental over the last few years --as a serious, coherent national trade and industrial strategy. The damage is everywhere: in shuttered factories, an agricultural sector near bankruptcy, markets here and abroad lost to foreign competitors, and the emergence of the United States as a debtor nation. Fortunately, there are important signs of change in the Executive Branch -- especially since September's official about-face in global currency intervention and trade commitment -- and the more Congress can further this trend, the better.

Not that shaping this kind of strategic approach and commitment will be easy. Until September, for a half decade or so, the President and the Congress -- at first in legitimate reaction against the federal regulatory over-involvements of the Nineteen Seventies -- have sought to roll back government. Efforts were made to reduce not only tax rates and domestic economic regulation, but also the role of the U.S. government in the international economy. Adherence to free markets and free trade has been the byword. Since September, a more sophisticated awareness seems to be taking hold. But skeptics will require action and implemention, not just an opportune season of rhetoric. And cynics will remember that previous proposals for a new Washington commitment to U.S. international competitiveness -- moderate, realistic ones largely shaped by the business community -- were rejected by President Reagan and his advisers as late as February 1985. "Chilly" is a resonable description of the reception given White House-commissioned blueprints like the late 1984 report of the President's Task Force on International Private Enterprise and the early 1985 report of the President's Commission on International Competitiveness. The largely-ignored Task Force report urged White House creation of an Economic Security Council to plot U.S. global economic strategy in the manner of the existing National Security Council. And the Commission followed by calling for a new federal department to orchestrate international trade and another to deal with science and technology. Some such new instrumentality -- be it a department or beefed-up council -- may well be necessary for this Administration or any other Administration to coordinate trade, tax, budget and monetary policy and their collective domestic and international impacts.

Not surprisingly, during this same pre-September period, the notion of a "strategy" to explicitly coordinate the various strands of government policy was also rejected out of hand. Here, too, the consequences have been inauspicious. In mid-September, U.S. International Trade Commission Chairman Paula Stern pleaded for change: "To win a war, you need a strategy. In international trade, however, we are operating with neither a battle plan nor a general staff. No wonder we are in full, disorderly retreat." Exactly. A few days later, the President and the Treasury Department finally action both on shaping a tougher strategy and promoting a dollar devaluation. However, if the "full, disorderly retreat" Paula Stern referred to is over, orderly strategizing still seems too ad hoc.

The unfortunate truth is that today's international economic policy crisis has been emerging -- largely unstrategized -- for several years. By 1982-83, the interacting 1981 federal tax cuts and post-1981 defense build-up were splashing the national economy in red ink. But the implications of the mushrooming deficits were ignored or denied. The highest real interest rates in fifty years lured foreigners to finance the U.S. deficit. Their demand sent the dollar rising on the currency markets. And, of course, the soaring dollar -- until mid-1985 hailed by officialdom as a proud new stanza to the Star-Spangled Banner! -- made imports into the U.S. cheap while making U.S. exports increasingly too expensive for previous overseas customers. So aided, the foreign rivals of U.S. agriculture and industry began to make enormous inroads into previously U.S.-dominated markets both here and abroad. Many of these will never be recovered; they are the price the United States paid for its early 1980s nonchalance.

Yet there is another, systemic reason for the United States to begin taking strategic political economics seriously. We are almost certainly in another one of history's periodic global economic watersheds. This is the world political-economics realignment to which I referred earlier. The geography of advanced production is shifting -- painfully. What used to be made in Pittsburgh, Lancashire, Lorraine and the Ruhr is migrating from West to East, from Europe and North America to Asia and Latin America. So is the technological edge that underpinned that hegemony. In the process, the United States is losing the post-World War Two manufacturing and commercial dominance that nurtured yesteryear's nonchalant trade policy approach. And without that American self-interest, the political basis of an international free trade system (or pretense) may vanish, too. Cautions and caveats abound.

Open markets are a precarious phenomenon, for one thing. A serious perusal of modern history -- defined in the period the Cambridge Modern History as beginning in 1493 -- suggests that free trade may be a latterday aberration. British economic thinkers Adam Smith and David Ricardo first articulated the concept early in the Industrial Revolution. Britain thereupon became the first world economic power to fully embrace free trade after parliament's repeal of the Corn Laws in 1846, a commitment maintained until the general tariff of 1932. The United States picked up the open markets banner soon thereafter. By contrast, the leading economic powers of the prior three centuries -- first Spain and then France -- had practiced the protective economic self-aggrandizement history describes as mercantilism.

So free trade is not necessarily a norm. U.S. policymakers cannot afford to assume it is a probable or logical state of global affairs. Arguably, for a dominant power to uphold it over several decades or even generations requires rare circumstances: The world's foremost manufacturing nation must also be the world's leading naval, commercial and technological power. Until more or less the early 20th Century, Britain occupied that niche. Then the United States fulfilled those criteria for at least three decades after World War Two. Now, however, the United States is being commercially threatened by East Asia much as this country and the Kaiser's Germany nipped at the heels of early 20th Century Britain. And U.S. free trade commitment seems to be ebbing at more or less the same stages of manufacturing decline that eroded free trade backing in late Victorian and Edwardian Britain. Japan and the "little dragons" of East Asia are hardly likely to pick up the banner, given the similarity of their economic practices to those of 16th Century Spain or 17th Century France. Let me stipulate: the United States may well be able to set up a regional free-trade bloc with Canada. It's late 20th Century reconstitution of an international free trade era that global political-economic circumstances suggest will be so tricky.

Interestingly, a considerable similarity between currentday U.S. trade politics and the earlier British metamorphosis underscores our strategic conundrum. At its mid-19th Century zenith, Great Britain boasted half the world's manufacturing production. By 1870, that share had declined to 32%, and by World War One, to about 15%. Demands for major modification of free trade were issuing from major segments of British heavy industry by the 1890s, and by the 1920s, most of the Conservative Party had gone over to protectionism. In 1932, tariffs and Empire Protection were finally enacted.

The parallel is all too obvious. Right after World War Two, the United States, like Britain a century earlier, produced roughly half of world manufactures. That was when Washington really promulgated U.S. commitment to free trade. As of 1980, with the U.S. share of world manufacturing turning down to little more than 20%, support for protectionism was growing. Now, five years later, trade is arguably on its way to being a top issue in U.S. politics, mirroring its prominence in British debate during the period (1890-1932) of that nation's late-stage, declining world economic preeminence. In short, the reasons for growing U.S. concern with the competitiveness crisis are substantially systemic. Much more is involved than transient currency misalignment pressures.

Under pressure of global neo-mercantilist realities, even some U.S. free trade economists have begun to wonder if their purely economic interpretation of the doctrine of ""comparative advantage" -- that goods are produced where economic advantage dictates -- may not have to be modified to also allow for the benefits of a collaborative national government. And they should be wondering. Suppose for a moment that the cynical political-historical analysis of free trade is correct and the world is slipping into what could be called a "neo-mercantilist" era. Then countries like the United States with governments that have generally spurned pro-export policies, currency alignment attention, business-government collaboration and strategic economic thinking must suffer. Many of their industries and economic sectors will be comparatively disadvantaged. Unfortunately, large elements of this transition and related U.S. sectoral slippage may already be a fact.

Under the circumstances, Washington's strategic abdication has become intolerable, and a three-pronged national industrial, trade and competitiveness agenda seems imperative to arrest and partially reverse these tides. Key components must include: 1) overt acceptance of both a necessary pro-active role of the federal government and high-level strategic coordination of U.S. economic policies; 2) implementation of a specific U.S. competitiveness agenda ranging from creation of a new trade agency to an overhaul and enforcement of the U.S. trade laws, reform of obsolescent antitrust law limitations, expansion of export finance and stepped-up U.S. attention to research and development and technological education; and 3) phased-in enactment of a new border-neutral U.S. consumption tax to simultaneously reduce the deficit (and bring down the dollar in orderly fashion), shift the present burden of taxation away from savings toward consumption, and re-orient the U.S. revenue system towards export-import sensitivity.

Fortunately, elements of the strategic transformation are already underway. No longer does the Executive Branch operate on its earlier presupposition that deficits and interest rates are unrelated, that tax reform and trade solutions need not contemplate one another, and that monetary policy can let the dollar strengthen without reference to the pain of farms and factories. The Treasury's new internationally coordinated effort to bring down the dollar is evidence of a profound transformation. This is all to the good. A globally-oriented antitrust overhaul is also underway. At this writing, however, too many people in Washington still oppose what should be the next step: a policy linkage by which tax overhaul also becomes a vehicle for dealing with the inter-related deficit and trade problems.

Let me begin with the need for high-level policy coordination. As of January, 1986, it seems imperative to promote institutional coordination of the various economic policies and government economic involvements that the Administration earlier regarded as unrelated and separable. Watchers identify the new Economic Policy Council under Treasury Secretary James Baker III as a force for strategic thinking, albeit falling well short of the Economic Security Council role proposed by the President's Task Force on International Private Enterprise nearly a year ago. Let us hope so. If the world is indeed heading into something resembling a neo-mercantilist era, development of this new economic realpolitik machinery will be critical to the United States.

Even apart from this new realpolitik machinery, U.S. policymakers should immediately undertake a study of the political-economic obsolescence of the whole range of international organizations the United States helped blueprint at the end of World War Two -- the UN, UNESCO, The World Court, GATT, etcetera. Because of changing global power equations -- new countries, new alliances, new economic circumstances and relationships -- these organizations no longer work as they once did. Certainly our interests are not being well-served. But the larger questions is whether these organizations are still plausible policy vehicles. It not, are new ones in order -- or politically achievable?

In addition to strategic thinking and global re-evaluation, new programmatic approaches are also necessary. For the United States to deal with the managed trade and neo-mercantilism increasingly apparent around the world, some new domestic organizational, developmental and legal weaponry is necessary. In my 1984 book, Staying on

Top: The Business Case for a National Industrial Strategy, I suggested fifteen measures. None were at all radical, and all were based on conversations with the heads of major national business organizations and on a synthesis of those organizations' policy agendas, as well as on my analyses of public opinion polls, of Congressional sentiment and other yardsticks of real-world political feasibility for a national competitiveness agenda. My thesis, directed at conservatives, was that policy activism does not have to conjure up economic planning councils and national industrial redevelopment banks. There is substantial support -- even the makings of a consensus -- for a centrist blueprint. Here is the framework that I thought sensible or politically plausible two years ago, some of which has since been enacted into law as ordered by the Executive Branch. It is all feasible; it is all doable.

Trade Law and Enforcement

1. Establishment of a federal Department of International Trade and Industry to foster U.S. competitiveness. (The Administration has lost interest, but some centralized trade agency still seems necessary)

2. Enactment of trade reciprocity legislation.

3. Fuller enforcement of existing U.S. trade laws. (How much of a solution the tougher trade approach set forth by the Administration in September can represent remains to be seen.)

4. Stepped-up federal monitoring and analysis of foreign national industrial policies.

5. Revision of U.S. trade laws to cope with subsidies and other aspects of foreign industrial policies.

6. Revision of U.S. antitrust policy to redefine anti-competitive behavior using global market standards and to allow U.S. corporations to collaborate on research and technology to meet foreign competition.

7. Expansion of the charter and lending activities of the U.S. Export-Import Bank. (The larger "warchest" now under consideration needs further expansion.)

Lobbying

8. Intensification of U.S. business lobbying overseas, plus more effective regulation of foreign lobbying in the United States. (The new proposed Wolpe-Kaptur bill to prohibit top U.S. officials from serving as foreign lobbyists for a period of 10 years after their resignations from government has some merit.)

Tax Policy

9. Appointment of a national commission on trade and taxation to recommend U.S. tax code revisions to spur international competitiveness. (With any luck, 1986 Senate Finance Committee hearings can serve much of the same purpose.)

Management-Labor Relations

10. Support for redirection of labor-management relationships, with particular attention to productivity incentives.

11. Consideration of new non-statutory Federal approaches to ameliorating industrial plant closings. (The new U.S. Labor Department Task Force look into the plant closing question has promise.)

12. Establishment of a displaced-worker retraining program modeled on veterans' benefits.

Research and Development and Education

13. Increased support of technological research, including creation of a "basic research trust fund."

14. Protection of U.S. technology against theft and espionage and toughening of U.S. intellectual property laws (copyright and patents).

15. Enactment of a Morrill Act (land-grant college) equivalent for scientific and technical education.

Public opinion polls show support for virtually all of these approaches. Indeed, the Reagan Administration is already moving on about half of these fronts. However, while individual measures are important, what's really needed is White House proclamation of a larger, cohesive competitiveness agenda. Piecemeal trade law revision is not enough. Neither is dollar-valuation gamesmanship. A program broad enough to rally public opinion is necessary -- not just in its own right but to underscore the scope and depth of Washington's new commitment.

Ingredient number three in a U.S. competitiveness strategy has become increasingly imperative: a tax increase -- but not just any tax increase -- to get the deficit under control. Enactment of a consumption tax, in particular, is the only way deficit-reduction can be conjoined with the sort of major overhaul needed to point the Internal Revenue Code toward trade and international competitiveness goals. It doesn't point there very well now.

As of early 1986, the best option is what's being called a Business Transfer Tax (BTT). A variation on a value-added tax, most versions would impose a 5% or 10% tax on business transactions, excluding the retail level. Like other VATs used around the world, it would exempt exports and apply to imports. In addition, corporations with American payroll FICA obligations or some other U.S. tax liabilities would be able to substantially offset those liabilities against their BTT payments. The net federal revenue proceeds, depending on the rates, exemptions and rebate mechanisms involved, would be somewhere in the $25-100 billion a year range. Calculations suggest that a large part of the burden could be made to fall on foreign firms sending goods into the United States.

A partial shift towards this type of taxation could benefit American competitiveness on three dimensions. First, it would raise revenue to begin reducing the deficit, thereby taking the pressure off real interest rates and the over-valuation of the dollar and its negative impact on trade. Secondly, movement towards a consumption tax could be used to reduce corporate income tax rates or retain various corporate tax incentives, thus assisting United States competitiveness by decreasing the burden on capital formation and savings while increasing the burden on consumption. Most of our trading partners raise a substantially higher percentage of their total revenues from consumption-type taxes. And thirdly, most value-added taxes, falling on imports and being rebatable against exports, encourage exports and tie national tax policy and national trade policy together. U.S. companies, by contrast, have non-rebatable taxes built into their export costs. Product competitiveness suffers.

Can there be a useful national trade and industrial strategy built around only one or two of the three components? Obviously. Practical politics is, after all, an incremental game. This three-part blueprint calling for commitment to economic realpolitik, to a broad-based competitiveness agenda and to a new consumption tax aimed at the budget and trade deficits and the over-valued dollar is arguably an ideal unlikely to be reached. Partial progress is better than no action at all. But given the $150 billion dollar trade deficit that stares us in the face, with its resulting greater than necessary dislocation of America's farms and factories and the possibility of ill-considered Congressional remedies, the sooner and the more fully we move in these directions the better.

Bluntly put, the lack of a U.S. competitiveness strategy has become intolerable -- and dangerous.

Kevin Phillips is a newspaper and broadcast commentator and publisher of the American Political Report. His most recent book is _Staying on Top: The Business Case for a National Industrial Strategy_.

Mr. **Cahill**. Thank you, Kevin, for that historical perspective.

One of the things that we didn't have in the mercantilist era was the multinational corporation. Raymond Vernon will tell us how the multinational has impacted our trade picture.

PRESENTATION OF RAYMOND VERNON

Mr. **Vernon**. That's a pretty ambitious agenda I've been assigned, but I'll do my best to measure up to it.

The first critical point I think to bear in mind is that the factors that lie behind the multinationalization trend in business are profound and, as nearly as anyone can tell in such matters, utterly irreversible. So that in all of our thinking we have to make the assumption that one of our policy nonvariables, one of the things we can't manipulate, is the global spread of enterprise in multinational structures.

That may seem an obvious point to you, but as I've listened to the language of both the representatives of Government and those of business today, it's obvious that that point hasn't penetrated. On both sides, there is talk about what "our" enterprise should do in response to the problems of a piece of turf called the United States of America. The critical point to bear in mind is that in geographical terms the two are presently disparate concepts. "Our" enterprises are now operating all over the world.

As you look at the U.S. based multinational enterprise from a global point of view, it's managed its affairs pretty well. Whether it has contributed to the current difficulties with respect to the trade balance is a lot more obscure than is ordinarily supposed. Just to illustrate the complexity of that question, probably on the order of 70 percent of the merchandise exports of the United States is performed by multinational enterprises. And foreign revenues from multinational enterprises account for something like 18 percent of our total export of goods and services.

Finally, one observes that multinational enterprises aren't all moving offshore from the United States. There is a flood of multinational enterprises coming into the United States from Europe and Japan. For the present, the appearance of foreign-owned subsidiaries doesn't improve our trade balance except as it reduces what might otherwise have been direct imports. But the point to be made is that the net effect of the multinational enterprises on the U.S. balance of payments is complex and obscure. It's not at all clear that on balance the multinational enterprise as an institution is contributing to the problem.

Yet, there are problems. It is possible that the most difficult of all is not fundamentally an economic problem but a political problem. We use our security export controls to extend the jurisdiction of the United States in ways that we regard as appropriate to our own security ends. We now use our powers as best we can to alter the internal policies of South Africa, aware how important it is in terms of global human rights that those policies should be altered. And we make these moves with a kind of innocent insouciance that is disconcerting. What will our reaction be when multinational enterprises based in other countries are used by their governments to influence the U.S. economy?

Another illustration of the important consequences of the growth of the multinational enterprises lies in the growing use of so-called performance requirements. Mexico asks an American U.S.-based automobile company to export more and import less. The U.S. automobile company, fearing to be expelled from the Mexican market, shuts down a line of production in Sao Paulo, Brazil, or Austin, TX. There is a shift of production invisible to the human eye. This kind of maneuver has become an increasing part of the beggar-thy-neighhor games that are going on all over the world. In this case the multinational enterprise is almost an innocent conduit, but its existence is critical to an understanding of trade currents in the world today.

Or take another issue, the issue of taxes. More and more, the only income figure that makes much sense for some of our multinational enterprises is the consolidated global statement of the whole network. For such enterprises, national income figures are obscure concepts created largely by the accountants' rules of thumb, based on arbitrary allocations of both sales on the one hand, and expenses on the other.

The issue has now arisen in an acute political form because the States have decided to take a very sensible approach to this problem and to look on this global income in many cases as the only real figure from which to work. The instinct of the national governments concerned, to resist that development, has been predictably wrong. Here again you see the interplay between the multinational enterprises as an entity that transcends international boundaries and the nation states' indispensable requirement to rule over its own piece of turf.

And finally, just to illustrate the pervasiveness of these kind of problems, we can turn to the interesting question of antitrust. About once every decade, the Americans do something rather extraordinary in the eyes of the world: They break up the Standard Oil trust or American Telephone. When they do, the other governments of the world wake up to discover that the subsidiary operating on their territory has been substantially changed. That may be OK in terms of American policy, but from the point of view of, say, a French bureaucrat this is an invitation to disaster.

The conflict among national philosophies as to the appropriate approach with respect to antitrust is something that is gradually beginning to increase in importance. Happily, American policymakers are beginning to recognize that something has changed in the world in terms of the structure of industry that requires another look at antitrust and I think that instinct is correct as far as it goes. It may fail to recognize, however, that problems of antitrust are only changing in form. Multinational enterprises are creating new alliances across international borders, and I fear that the antitrust issue will probably arise in new contexts.

Let me wind up by saying that there are no good guys and no bad guys in this story. Multinational enterprises are doing precisely what they were set up to do. They are producing and selling and moving technology wherever they see a reasonable profit to be made. The odds are that they are doing more good than harm from a global viewpoint. But they are a system which the Lord never conceived of when He thought of the idea of nation states. Governments must reconcile themselves to the continued existence of such enterprises. And they must recognize that dealing with the associated problems of jurisdictional conflict by unilateral action will get them nowhere. The only responses that in the long run are going to work are those that achieved international agreement.

[The complete presentation of Mr. Vernon follows:]

THE SPREAD OF MULTINATIONAL ENTERPRISES:

IMPLICATIONS FOR U.S. POLICY

by

Raymond Vernon
January 17, 1986

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THE SPREAD OF MULTINATIONAL ENTERPRISES: IMPLICATIONS FOR U.S. POLICY

by

Raymond Vernon

The Main Trends

Since the end of World War II, most of the world's largest manufacturing firms have been transformed from national firms to multinational enterprises. These multinational enterprises, by building up a network of subsidiaries and affiliates outside of the home base in which the parent is located, have greatly enlarged the scope of their production and marketing operations, covering much larger areas of the globe than in the prewar period.

The development has been worldwide, affecting large enterprises headquartered in all countries, from Holland to Hong Kong. But the development has been especially evident with respect to enterprises in which U.S. policymakers are obliged to take a special interest, namely, those headquartered in the United States, such as General Motors and IBM, and those headquartered in foreign countries with subsidiaries operating in the United States, such as Toyota, Philips Electric, and ICI.

The growth and spread of multinational enterprises has contributed heavily to opening up the borders of the U.S. economy, enlarging and strengthening its direct links with the economies of other countries. Some crude indications of

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* I am grateful for the research support provided by Debora Spar.

the importance of those new links to the U.S. economy are provided by the data in Table 1. Because the direct investments of U.S. firms abroad are of an earlier vintage on the whole than the investments of foreign-based firms in the United States, the book figures in the table are not altogether comparable, tending to understate the relative size of the U.S. holdings abroad. Nevertheless, the figures in Table 1 firmly establish two points: that the foreign links achieved through direct investments in the United States are growing rapidly, and that in absolute terms they have already achieved very considerable proportions.

In terms of the manufacturing jobs they employ, multinational enterprises have become a major factor. In 1977, U.S.-based manufacturing firms employed 3.9 million persons outside the United States. And in 1980, the U.S. manufacturing subsidiaries of foreign-based firms employed about 1.1 million persons. For purposes of comparison, the total U.S. workforce engaged in manufacturing in these years was in the neighborhood of 20 million.[1]

In addition to the role that multinational enterprises have come to exercise as a source of employment in manufacturing, their role in the U.S. balance of payments also has acquired significant dimensions. In 1984, for instance, the income that U.S.-based parents received from their foreign establishments came to $66 billions, representing 18 percent of all U.S. exports of goods and services. The payments made to foreign firms in connection with their direct investments in the United States in 1984 was much

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[1] Data on the transactions of multinational enterprises in the paragraphs that follow are taken from various issues of the Survey of Current Business from 1979 to 1983.

TABLE 1

U.S.-based Firms' Direct Investment in Foreign Countries and Foreign-based Firms' Direct Investment in the United States (based on year-end book values in billions of U.S. dollars)

U.S.-based firms in foreign countries	1950	1960	1970	1980	1984
Manufacturing	$3.8	$11.0	$31.0	$89.0	$93.0
Petroleum	3.4	10.8	19.8	47.0	63.3
Other	4.6	10.0	24.7	77.5	77.0
Total	11.8	31.9	75.5	213.5	233.4
Foreign-based firms in the U.S.					
Manufacturing	n.a.	2.6	6.1	24.1	50.7
Petroleum	n.a.	1.2	3.0	12.3	25.0
Other	n.a.	3.1	4.2	29.1	83.9
Total	n.a.	6.1	13.3	65.5	159.6

n.a. - not available

SOURCES: Various issues of Survey of Current Business.

lower, amounting in 1984 to less than $11 billion; but that figure can be expected to climb rapidly in the years to come.

The international trade generated directly by these multinational enterprises also was impressively large. The aggregate merchandise exports and imports of these enterprises have not been fully reported in recent years; but in 1965, U.S.-based multinational enterprises accounted for 66 percent of all U.S. merchandise exports, and by 1977, the figure had run over to 70 percent.

This growth in the inward and outward flows of foreign direct investment has profoundly affected the outlook of U.S.-based enterprises, turning them from firms focussing on the U.S. market to enterprises that make production and marketing decisions in a context of global competitors and global markets. Once again, various statistics reflect this shift in focus. By 1980, for instance, Ford, IBM, and ITT reported over 50 percent of their sales as arising in foreign markets.[2] For U.S.-based corporations as a group, the analogous figure in 1977 was 32 percent, and for the manufacturing firms in the group 29 percent.

To be sure, not all U.S.-based firms have been expanding their multinational networks in the past decade. In a few industries, in fact, the predominant tendency has been withdrawal and retrenchment. In copper and petroleum, for instance, and in some branches of the chemical industry, some observers have speculated that the multinational trend might be coming to an end. History tells us, however, that the decline of multinational firms in some industries is no indication of an overall decline in multinational networks as a whole. Since the time when such multinational networks first developed about a century ago, some firms that had developed a multinational structure have been obliged to give up that structure in reaction to certain other changes in their industry. In a cycle that is sometimes referred to as "the obsolescing bargain," enterprises are often compelled to shrink back when they no longer possess special competitive advantages--advantages that are usually embodied in a special capability to mobilize capital, to provide difficult managerial or technological skills, or to provide access to hard-to-enter foreign markets. In earlier eras, multinational enterprises have lost their own advantages in tropical agriculture, in various types of mining, in the electric-generating industry, and in traction companies. More recently, multinational enterprises in some other industries including oil appear to have lost these special advantages and have been obliged as a result to cut back the scope of their foreign operations. But by and large, the underlying trend to multinationalization has been sustained.

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[2] U.N. Centre on Transnational Corporations, Transnational Corporations in World Development, Third Survey, New York, p. 357.

Indications of the strength of the underlying trend are ubiquitous. One telling indication is reflected in the data in Table 2. The figures reflect the profound consequences of a fundamental learning process that U.S.-based firms experienced in the years from 1945 to 1975. In the earlier years, U.S. firms were in no great rush to set up facilities abroad to produce the innovations that were coming out of their laboratories and being introduced in U.S. markets. By the end of three decades, however, the lag between their first U.S. production and their first overseas production had shortened considerably. What is more, the degree of such shortening was a faithful function of the firm's prior experience in the particular country and with the particular product.

More recently, indications of the persistent vitality of the multinational enterprise have been seen in the rapid expansion of foreign-based enterprises in the U.S. market already mirrored in Table 1, a result of increased direct

TABLE 2

Transfers of 406 Innovations by 57 U.S.-based Multinational Enterprises to their Foreign Manufacturing Subsidiaries: Classified by U.S. Introduction

Innovations classified by period of U.S. introduction	No. of Innovations	Same year or 1 year after	2 or 3 years after	4 or 5 years after	6 to 9 years after	10 or more years after	Total
1945	34	8.8%	14.7%	2.9%	11.1%	43.3%	82.8%
1946-1950	79	11.4	15.2	10.1	14.1	39.3	90.1
1951-1955	57	7.0	5.3	15.8	25.4	32.5	86.0
1956-1960	75	16.0	21.3	16.0	20.0	18.7	92.0
1961-1965	63	26.9	17.6	14.3	7.9	8.1	74.7
1966-1970	64	28.2	17.2	12.5	6.2	n.a.	64.1
1971-1975	34	38.2	26.2	n.a.	n.a.	n.a.	64.4
Total	406	18.7%	16.3%	11.6%	14.3%	20.2%	81.1%

n.a. - not applicable

SOURCE: Vernon, Raymond and Davidson, W.H. "Foreign Production of Technology-Intensive Products by U.S.-Based Multinational Enterprises," Report to the National Science Foundation, no. PB 80 148638, January 1979, Table 11.

investment mainly on the part of European-based and Japanese-based enterprises. At the same time, increasing numbers of smaller firms have taken to forming multinational networks. In the United States, for instance, by 1977 the number of manufacturing firms with less than $25 million in assets that had acquired one or more foreign subsidiaries reached 622; and preliminary results from a 1982 survey indicated that the figure would be substantially higher for that date.[3]

Patterns of Operation

Until quite recently, economists in the United States felt no great need to puzzle out the economic implications of the growth of multinational enterprises, leaving that line of inquiry largely to their colleagues in the developing countries, in Canada, and in Europe. It was obvious that multinational enterprises tended to internalize various international flows of goods, services, and money, so that the flows took the form of transfers between related units in a single multinational network. But it was widely assumed that the internal decisions of the multinational enterprise would create international flows of goods, services and money that roughly approximated those reached by unrelated firms operating at arm's length. Today, however, few economists who have studied the multinational enterprise phenomenon would cling to that assumption. Although serious efforts to articulate those differences in conventional economic terms and to measure the differences econometrically are still fairly rare, some strong hints of the nature of those effects already exist.

The decisions of multinational enterprises in expanding, contracting, or shifting their productive facilities around the globe are likely to produce patterns that are significantly different from those that would develop from the decisions of independent national producers. The likely sources of those differences are numerous; but a few are worth mentioning.

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[3] Survey of Current Business, October 1981, p. 46.

One factor is simply the cost to the firm of acquiring knowledge about alternative locations in foreign countries, as well as the credibility attached to that knowledge after it is acquired. As was pointed out earlier, the prior experience of an enterprise with producing in a given foreign country measurably speeds up the decision to set up more production facilities in that country. The information that planners at the headquarters of multinational enterprises receive from their subsidiaries in the field is likely to be less costly and to appear more credible than information gathered from external sources. Enterprises that are in a position to receive credible information swiftly and at low cost, one can assume, are likely to react more swiftly and more sensitively than others.

Another reason for anticipating that multinational enterprises will produce a distinctive locational pattern stems from their ability to play off competing national jurisdictions against one another, especially when they are locating plants that are to produce for export. In such situations, in addition to looking for an environment with a favorable cost structure, enterprises often look for the most attractive package of subsidies and tax exemptions being offered by competing governments. The implications of that practice should not, of course, be exaggerated. Factors other than these governmental blandishments have a considerable influence in the locational decisions of firms. For instance, multinational enterprises cannot place their exporting plants in locations that might bar them from their intended market. Despite the caveats, however, the subsidies that governments offer cannot fail to affect the locational decisions of the multinational enterprises.

Perhaps the most effective device by which governments have influenced the investments of multinational enterprises in their productive facilities, however, is through the so-called performance requirement. Most governments in developing countries and some in industrialized economies make a practice of imposing specific performance requirements on the subsidiaries of multinational enterprises, such as the requirement to export more and import less; subsidiaries that fail to measure up to such requirements are usually threatened by the possibility of being barred from selling those products in the national market.

Performance requirements, it is apparent, represent a relatively new and virulent form of begger-thy-neighbor tactics among competing governments. A typical response by a multinational to Mexico's demands, for instance, would be quietly to reduce the production of subsidiaries in, say, Brazil or the United States, in order to expand production in Mexico. When more than one government is making demands of this sort on a multinational enterprise, the enterprise is cast into the position of mediating between the demands of different governments by inconspicuously redistributing production among its various affilitates. All told, then, the multinational enterprise introduces a relatively new force in the distribution of international trade and investment, a force that operates on patterns that may be quite different from those contemplated in the traditional view of international trade and investment conducted at arm's length between independent parties.

Lines of Policy

The mushrooming of multinational enterprises has been affecting various areas of U.S. policy with increasing frequency. In some cases, the growth of such enterprises has exacerbated some long-standing issues, such as the protection of the foreign assets of U.S. citizens, the U.S. taxation of foreign income, and the U.S. prosecution of antitrust suits. In other instances, the growth of multinational enterprises has figured in some quite novel situations, such as the use of such enterprises to promote human rights, the avoidance of injury in the international sale of harmful products or technologies, and the avoidance of threats to the safety of bank deposits in the United States. Many of these issues are of sufficient importance in U.S. international economic relations to merit a few words of elaboration.

The antitrust issue. One familiar set of problems that promises to grow in intensity over the years stems out of the antitrust policies of the United States.

By law, the Federal Trade Commission and the Department of Justice are responsible for worrying whether proposed mergers, consolidations and joint ventures among competing U.S. firms are likely to impair competitive conditions in U.S. markets. In making such judgements in individual cases, these institutions are guided by various rules of thumb that are incorporated in precedent and in law. Those guides have been fashioned on the assumption that whenever the sales of a given product become more heavily concentrated in the hands of a few sellers in the United States, the increase in concentration may constitute a threat to competition in the U.S. market.

The measures used to determine if competition is being threatened, however, are anachronistic in light of the rapid growth of multinational enterprises. However relevant they may have been some decades ago, they have been rapidly losing their meaning under modern conditions of competition. In a world increasingly populated by multinational enterprises, measures that rest on the degree of concentration of sales in the U.S. market become unreliable. Multinational enterprises, relying upon their existing outposts in the principal markets of the world, are in a better position to recognize new market opportunities in foreign countries than national firms would be. Their ability to compete in those markets is measured not by their past sales in such markets, but by their capacity to respond to the opportunity created by abnormal profit margins. Measures of concentration, therefore, can be acutely misleading; where high concentration exists in an industry, it need not mean that the existing sellers can act with impunity. And, in fact, multinational enterprises that have dominated U.S. markets in given product lines are often acutely aware of their vulnerability.

The challenge of antitrust doctrine is to find some operational standards that reflect this changed state of international competition. Obviously, actual imports and the threat of imports have to be taken into account in such revised standards. But beyond that, the extent to which competitors may set up new subsidiaries in U.S. markets also ought to be reflected in any ideal measure.

Another problem for antitrust doctrine that arises out of the growth of multinational enterprises is one of longer standing--but one that is gradually growing in intensity. This is the problem of jurisdictional clash, especially between nations with incompatible approaches to the subject of restrictive business practices, or incompatible interests in the maintenance of some specific restrictive practice.

The efforts of U.S. prosecutors to command data from alleged foreign "co-conspirators" and even from innocent foreigners not partaking in the alleged violations, as well as the efforts of U.S. courts to shape remedies that would apply to foreign enterprises engaged in such violations, have produced bitter reactions in foreign countries, notably the United Kingdom, France, Canada, and the Netherlands. Some governments, indeed, have enacted laws prohibiting their residents from responding to the requests of U.S.

agencies for data in antitrust cases. The problem is particularly difficult for the United States because of the separation of powers between the U.S. courts and the U.S. executive; while some judges have been sensitive to the problems of jurisdictional conflict, others have felt free to make demands on foreigners without regard to the political consequences of such demands.

In years past, the U.S. government has made sporadic efforts to develop some modus vivendi for dealing with these jurisdictional conflicts. A provision for consultation on restrictive business practices has been worked into a number of bilateral treaties with other industrialized countries. The United Nations Conference on Trade and Development has developed some nonbinding principles that might guide governments in the handling of international restrictive business practices. But these have been cosmetic gestures rather than serious efforts to reconcile conflict.

The possibility that some resolution could be achieved in the years ahead is enhanced by a number of developments. First, measures taken by the European Economic Community in this field, such as the prosecution of IBM on antitrust grounds, have occasionally appeared objectionable in jurisdictional terms to the United States. Second, Europe-based and Japan-based multinational enterprises have greatly expanded direct investments in the United States. Developments such as these suggest the likelihood that in the future the U.S. economy will find itself on the receiving end of measures taken by other governments that seem inconsistent with U.S. concepts or interests in the field of restrictive business practices.

In the absence of some resolution of conflicts such as these, one can easily foresee two possible consequences: The United States and other countries will clash over these issues with increasing frequency; or countries will draw back from enforcing their national antitrust statutes whenever foreign interests are involved, simply because they are unwilling to take on the burden of the international political consequences. Some evidence exists for the prevalence of both tendencies. Needless to say, either outcome will be costly to U.S. interests.

Accordingly, the time may be ripe for resuming U.S. support for an effective international modus vivendi in this area. The tendency of the United States to limit its support to hortatory statements of large principles may no longer be sufficient. Instead, changing circumstances call for an explicit set of guidelines for the resolution of conflict, plus some means for finding facts and reconciling conflicts in undecided cases.

Pressures for political ends. The U.S. government has repeatedly used the foreign networks of its multinational enterprises to apply economic pressure on other countries for political ends, with results that have sometimes been politically disastrous. As a rule, the American strategic objective has been to hold down the warmaking capabilities of the communist countries, including not only the U.S.S.R. and Eastern Europe, but also Cuba, Angola, and Nicaragua. At other times, however, the U.S. government has had other aims in applying economic sanctions, including efforts to enforce its concept of human rights, as witnessed by the Southern Rhodesian and South African cases.

These uses of the multinational enterprise tread on extraordinarily delicate ground; but the delicacy of using multinational enterprises for political ends has not registered very strongly in the United States as long as foreign direct investment has played no important role in the U.S. economy. Countries adversely affected by such U.S. policies might occasionally express their discontent over our measures; but as long as the United States was not the aggrieved party, their complaints carried little weight in the U.S. process.

Today, however, foreign direct investment in the United States is approaching $200 billions. Other countries, therefore, are increasingly in a position to play a similar political game. Domestic reactions to the efforts of Arab countries to boycott Israel hint at the political storm that could be provoked as other nations attempt to exploit the participation of their multinational networks in the U.S. economy. From the U.S. viewpoint, the Arabs' goals were much harder to defend than are the goals that the United States seeks to achieve in South Africa; but in the absence of any international standards regarding the use of multinational enterprises for such restrictive actions, the intrusive character of such measures is bound to evoke bitter political reaction.

The larger issue in which these cases are embedded is the extent to which governments should use subsidiaries of multinational enterprises for political ends. The problem is usually thought of as one in which the country of the parent firm seeks to influence the country in which the subsidiary is located. But the possibilities of political pressure actually can run as well in the opposite direction. Governments in which important subsidiaries of multinational enterprises are located can attempt to hold the subsidiaries hostage in order to squeeze changes in policy out of the governments of their parents; oil-exporting countries in the Middle East toyed with such a strategy repeatedly during the decade of the 1970s, hoping to alter the direction of U.S. policy toward Israel.

Problems such as these are often indistinguishable from two related problems. To what extent should foreign subsidiaries of multinational enterprises be entitled to engage in the normal political activities of the countries in which they are located? And to what extent should they be entitled to call upon the governments of the parents for diplomatic support?

These questions have been a source of many bitter disputes in international relations, disputes that have produced little more than unilateral declarations by the various parties.

Although disputes of this kind are less frequent today than they were five or ten years ago, the lull is almost certainly transitory, the result of governments being prepared for the time being to overlook such problems in order to acquire new sources of foreign capital. In the longer run, these controversies are bound to grown in number and intensity. Because many governments are identified with long-held positions in such disputes, reaching agreement on principles will not be easy. Yet in the absence of agreement, the issue will constitute another significant source of strain in international relations.

Pressure for economic ends. Multinational networks offer a tempting target for governments to pursue not only political objectives but economic ones as well. Perhaps the most obvious maneuver of that sort is the so-called performance requirement mentioned earlier, a requirement that usually takes the form of directing the subsidiaries of multinational enterprises to export more and import less, on pain of losing access to the domestic market of the country in which they are situated.

Once again, however, it is well to emphasize that the problem of performance requirements does not always run from subsidiary to parent. When parents limit a foreign subsidiary's sales to specific markets, such as the national market of the country in which the subsidiary is located, in effect they are imposing a performance requirement on the subsidiary, obliging it to surrender export business to other affiliates. When that allocation is influenced by the home government of the parents, as has been the case in a few well-publicized instances, the parallel with the performance requirements of host countries is even more marked.

These practices are well known to the policymakers of the United States and other countries, a growing form of beggar-thy-neighbor tactics on which no vigorous international assault has yet been made. In importance, the problem takes its place alongside other more visible barriers to trade. Perhaps, in the end, it can be dealt with most efficiently as a trade barrier. Meanwhile, however, it is important that the problem should be recognized as one peculiarly associated with the growth and spread of multinational enterprises, hence one likely to grow in importance as such multinational enterprises grow.

The tax issue. The various affiliates that make up any multinational network commonly draw on a joint pool of resources including management, technology and capital, and commonly pursue a strategy that is related to that of other affiliates in the same network. IBM's centralized research, for instance, affects the product of all its manufacturing subsidiaries; and IBM's sales force in any country relies on the general reputation and explicit technical support of the entire global network. Accordingly, the profit that each affiliate reports in any national taxing jurisdiction in which it operates has to be arbitrarily determined to some extent. To be sure, every taxing jurisdiction has its regulations and guidelines to assist the enterprise in determining that profit. But as a rule, there is still plenty of room for the allocation of central office overheads, the fixing of prices for the sale of technology and intermediate products among the affiliates, and other decisions determined according to the accountant's craft.

Recognizing some of the arbitrary elements that are involved in the division of taxable income among affiliates in the same multinational network, governments in most industrialized countries have entered into bilateral tax agreements with other industrialized countries, aimed at ensuring some degree of consistency in what each jurisdiction defines as taxable profits; the aim in such agreements is to spare the multinational enterprises the pain of double taxation while ensuring that one or the other taxing jurisdiction levies on the income that has been generated.

For a time, these bilateral agreements seemed sufficient to deal with the problem, at least as it related to relations between the advanced industrialized countries. Then some individual states in the United States, building on a practice that they already applied when calculating the taxable income of U.S. firms, decided to calculate the taxable income of multinational enterprises falling in their jurisdiction as a percentage of the global income of those enterprises. States following that practice normally determine the appropriate percentage by calculating the proportions of global assets, sales, and employment of the enterprise that fall within the state and basing the allocation on those percentages.

From the viewpoint of any state, this is a perfectly plausible calculation, more transparent than a calculation based on the numerous arcane allocations that accountants are obliged to make in pursuing the fiction that the activities of the enterprise in the state constitute a distinctive business unit with a distinctive profit. From the viewpoint of the multinational enterprise, however, the method suffers from two drawbacks: It prevents them from allocating their costs, as they would otherwise be inclined to do, in order to avoid having too much of the global profit appear in high tax jurisdictions; and it exposes them to the possibility that each taxing jurisdiction will elect the method it thinks will generate the highest taxable profit in its jurisdiction, thus exposing the enterprise to the risks of double taxation.

The protests of a number of countries against having the various states in the United States elect the global allocation approach may succeed in pushing

U.S. policymakers toward banning such state practices, forcing a reversion to the accountant's use of arcane and arbitrary allocations of income and expense among the states. A more defensible approach would be explicitly to acknowledge the fact that for many enterprises, it makes no sense to think of a profit arising within a single state, or even a single nation. In such cases, the objective should be to secure the widest possible adoption of the global allocation approach at all levels, national and sub-national. Otherwise, the determination of profit in any jurisdiction is almost certain to remain opaque, being determined largely by the arbitrary allocations of the taxpayers' accountants. This is an issue that promises to increase in intensity as multinational enterprises based in many different countries expand their networks over the globe.

Unfinished business. The subjects explored above should be thought of as no more than illustrations--illustrations of the consequences of jurisdictional conflict arising out of the growth of multinational enterprises. In fact, numerous other illustrations could have been used: problems arising from the transmission of dangerous industrial technologies or products, such as those involved in the Bhopal affair; problems involving the protection of bank depositors; problems involving the disclosure of corporate affairs for the protection of investors; and so on.

The list of such issues is daunting, given their number and variety. The temptation is to sweep them altogether in a single package, to label the package "multinational enterprise" or "transnational corporation," and to hope that some single international institution will be able to deal with them all. Any such expectation, however, would be illusory. Within any country, each of these diverse problems characteristically evokes its own unique set of responses. Some are handled at local levels of government, some at national levels. Some are dealt with by rule of law, some by administration, some by contract, some by benign neglect. Similar choices will have to be made at the international level. And if these international efforts are to be more than gestures of exhortation, the institutional arrangements for implementing those efforts will probably prove as varied as those devised within national jurisdictions.

Mr. **Cahill**. Thank you very much, Mr. Vernon. It sounds very much like we're right back in the global village.

As I said in my introductory remarks, Howard Samuel is the man in the trenches and I suppose typically the guy in the trenches gets the last word.

PRESENTATION OF HOWARD D. SAMUEL

Mr. **Samuel**. For some people it's the dessert. Thank you, Mr. Chairman.

Like two of the other panelists, I'm going to be dealing with a highly complex economic subject without any special training in economics. With apologies to my friend, Ray Vernon, I have to confess I have not found this an overwhelming handicap so far.

For almost 30 post-war years the American industrial worker could count on a growing economy and expanding opportunities to improve his and increasingly her standard of living and security on the job.

Today those dreams are shattered. The world of the American industrial worker is upside down. There is not much need for me to report the litany of statistics testifying to our present condition. It starts with a single most convincing statistic, almost 2 million manufacturing jobs gone, presumably forever.

It continues with thousands of plants closed every year, approximately a half a million workers displaced from their jobs, with a steadily increasing trade deficit in manufacturing, with a long-term loss of market share for U.S. goods, both at home and abroad.

The impact has been overwhelming on almost every manufacturing sector—on nondurables, on durables, even on high technology. Despite this impact, I want to reassure the members of the committee and this audience that American labor, by and large, has not turned its back on the need for international trade or rejected the inevitability of global interdependence.

I don't know if the spirit of Smoot-Hawley was viable in the past. I do know it is not viable today or tomorrow. But we also know that Adam Smith did not have the last word to say on the subject of international trade, that the invisible hand that is supposed to govern the free market frequently seems all thumbs, that the recovery of the American economy cannot be predicated on some of the myths being promulgated today in the press, in academia, and even in Government—present company excepted of course.

For example, there is the myth that our trade problems resulting in our current horrendous deficit are only temporary and will disappear when the dollar reaches a proper evaluation. Unfortunately, we can remember very clearly that the trade problem began to affect major sectors of American industry during the 1960's and 1970's when the currency was regulated or when the dollar was undervalued. We also know from the report of the President's Commission on Industrial Competitiveness that we have been losing world market share since 1965.

Second, there is the myth that the manufacturing sector really doesn't matter, that we can flourish as a service society. The result would be, of course, that we would buy our steel and autos and apparel and computers abroad and sell our services to pay for them.

The trouble is that many services are tied to goods production. If we no longer produce computer hardware, we won't be producing the software either.

Third, the three largest areas of service—health, education, Government—are not exportable. There is a variation on this myth, that we should give up all manufacturing except high technology. Well, first, that doesn't leave us much, perhaps 5 percent of all manufacturing can be classified as high technology. Also, much of the high-technology production is tied to more traditional production.

Again, an example: if Japan ends up making all our autos, they will surely make the computers which go into them. There is also every reason to believe that high technology is just as vulnerable as smokestack industries to the pressures of internationalization. Technology no longer is a factor endowment that can give anyone a comparative advantage for more than a week or two.

Finally, there is the myth that we've lost the ability to compete because of our high wages. All we have to do is to get down to the level of our competitors and we will conquer the world. Well, that's almost too silly to respond to, except to note, unfortunately, that we are indeed headed in that direction. Real wages have been steadily declining for more than 10 years. Workers are earning less today than they did in 1973, but it hasn't helped the trade balance a bit, has it?

What does labor propose to do about all this? As I indicated before, we are not looking back longingly to Smoot-Hawley. Blocking all trade at our borders cannot be the answer. Instead, the answer must be based on an understanding that we are facing a long-term crisis caused by long-term global changes and we must be prepared to develop new policies and create new structures to meet the challenge.

Part of the problems must be met through changes in the way we conduct international trade. Today we are the only major trading nation which still believes that the free market should be left completely to itself to dictate our economic behavior. Our competitors practice an active trading policy. We prefer the passive mode. The result is that decisions made in foreign ministries of trade determine American industrial success or failure.

Example, Europeans limit the imports of Japanese vehicles. The overflow inundates our market.

We are also the only major trading nation which does not bring the major players together, in our case, management, labor, and government, to improve the flow of information and to design remedies for problems. We have a different system. Wait until crisis hits, then respond to the political necessities. That hasn't worked very well.

At this point some of my listeners are going to discern signs of industrial policy and cry "Foul." Well, I plead guilty. Maybe we'll have to change the name. I will happily accept industrial strategy or competitiveness framework or what have you. But in the long run we must shed some of our dedication to Adam Smith and take a lesson from our successful competitors in developing international economic policy. They long ago turned away from Adam Smith on camparative advantage and, instead, adopted Clausewitz on war and it seems to have worked very well indeed.

Within the confines of trade law, we would make a number of major changes. Our unfair trade laws are too loosely drawn and inadequately administered. A recent example. We waited until the Japanese had captured more than 90 percent of the market for 256K RAM chips before we threw a dumping charge at them which would oblige them to raise their prices. It reminds one of tossing Bre'r Rabbit into the briar patch. Raising prices is exactly the goal of every corporate executive who gains dominant market share.

There are similar inadequacies in our laws regarding trade disruption, the escape clause. The escape clause proceeding should provide us with the opportunity to bring labor, management, and government together to develop a modernization program so that at the end of a period of relief the industry could once again compete successfully. Such a framework does not exist today. As a result, most industries emerge from their relief period in the same condition as they entered it.

Also, our trade laws should provide for greater focus of authority within the administration so that enforcement is governed by a single policy and, indeed, so it would be possible for the administration to develop a trade policy in the first place.

Today our trade authority is so atomized and so encumbered with political baggage that we cannot produce a comprehensive trade policy and we never have. Slogans, yes. Trade policy, no.

Meeting the challenge of internationalization will require much more than changes in our trade laws. Our ability to compete is influenced much earlier. For example, at a time a youngster drops out of high school and thereby enters the labor force, if he is lucky, without the skills needed for a period of technological change. It is influenced by the cost of capital in the United States, which is far higher than the cost in a number of our competitors. it is influenced by the state of our roads and bridges and transit facilities which are slowly but surely deteriorating. It is influenced by the insecurities of millions of workers who are threatened by economic change and have nowhere to turn for an adequate response.

An effective trade adjustment assistance program is one answer, but a far better answer would be a broad program of income supports, training, and retraining programs, job counseling, job search or relocation help, which would swing into action the day the factory door closes. To make such a program effective, both labor and management agree that advance notification of layoffs or closings is a requirement. That recognition should be incorporated into law.

Today I would state that American labor is not as optimistic about the future as it has a right to be. Internationalization has produced not the bright new glorious world that we had been promised, but a landscape strewn with dying industries, closed factories, eroding communities, and millions of workers and families in trouble.

To paraphrase the song, "Trade starts with a T, and T stands for Trouble," but it shouldn't. It shouldn't because 40 years ago we passed a law which said that our goal must be to provide employment opportunities for everyone who needs or wants a job. And today we have more people without jobs in a period of ostensible prosperity than we've ever had in our history. We are seriously disturbed about the job loss occasioned by internationalization and by the casual response of Government to this violation of the promise of the Employment Act.

I hope that, Mr. Chairman, that these hearings help focus attention once again on that promise and that we turn our national attention to the policies and programs needed to make it come true.

Thank you.

[The complete presentation of Mr. Samuel follows:]

Statement of the Industrial Union Department, AFL-CIO

By Howard D. Samuel, President

On Meeting the Challenge of International Competition

Before the Joint Economic Committee
Cannon Caucus Room
January 17, 1986

Industrial Union Department, AFL-CIO
815 Sixteenth Street, N.W., Washington, D.C. 20006
202/842-7800
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Elmer Chatak, *Secretary-Treasurer*

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About IUD

The Industrial Union Department is the largest of the AFL-CIO's constitutional departments, with 57 affiliated unions representing 5½ million members.

As a constitutional department, IUD is a semi-autonomous branch of the AFL-CIO. The department is financed directly by per capita payments from its affiliates. It is directed by a president and a secretary-treasurer who are elected at biennial conventions. The governing body is an executive council composed of the two officers and 24 members, who are principal officers of affiliated unions.

History

The IUD stems from the 1955 merger agreement between the AFL and the CIO, which provided for a new industrial union department within the merged federation. Walter Reuther, then CIO and UAW president, was elected its first president.

Reuther was succeeded in 1968 by I W Abel, president of the United Steelworkers of America, who served until 1977. Jacob Clayman succeeded Abel for one term, until 1979, when Howard D Samuel was elected president and Elmer Chatak, secretary-treasurer. Clayman had served as IUD secretary-treasurer from 1975 to 1977. James Carey, former IUE president and CIO secretarial treasurer, was the department's first secretary-treasurer, in office from 1955 to 1965.

Function

From its inception, the function of IUD has been to provide support services to affiliated unions in those areas where they share common concerns and where special efforts are needed to supplement the work of individual unions and the AFL-CIO.

IUD has a tradition of working with coalitions to strengthen labor's position on key issues. The department helped create the OSHA/Environmental Network, the Full Employment Action Council, the Consumer Federation of America and a number of others.

Programs

Organizing – More than one-third of IUD's resources are devoted to organizing. The department initiated the concept of cooperative organizing under then President Reuther in 1963, and has provided major support for many organizing campaigns since then. Under this approach, unions assign their organizers to work under the direction of an IUD coordinator. The method encourages cooperation among affiliates through the pooling of available resources and virtually eliminates jurisdictional disputes. The organizing section is located in Atlanta, Ga., with field offices in the Mid-South and Southeast.

Coordinated Bargaining – Another hallmark of IUD is coordinated bargaining, which brings together different unions having contracts with the same company to give them stronger leverage at the bargaining table. More than 40 unions participate in 71 different company committees, involving about 2,200 bargaining units and three-quarters of a million workers.

Safety, Health & Environment – Ever since it played a leading role in passage of the 1970 Occupational Safety and Health Act, IUD has taken the initiative in the courts and in legislative battles to assure proper implementation of the law. Through its work with the OSHA/Environmental Network, the department also has helped defend environmental protections.

Economic Policy – IUD has responded to downturns in the economy by examining and calling attention to the long-term problems faced by America's industrial sector. The department is a prime mover in efforts to develop a national industrial policy for the U.S. that will revitalize the industrial sector.

International Trade – This area has been an important concern to IUD because of the enormous impact that the policies of foreign governments have on U.S. industries and industrial union members. IUD continues to develop analyses, educational efforts and legislative approaches to key areas of trade policy, often through coalition activities.

Pensions – IUD monitors regulatory and legislative activities that could affect the status of benefit plans negotiated by its affiliates. The investment policies of private pension plans are an area of special concern for the department, which publishes *Labor & Investments*, the principal publication in this field.

Howard D. Samuel
President

Howard D Samuel's career in the labor movement has spanned more than 30 years, and culminated in his election as president of the IUD in September 1979. For most of the period 1949-77, he was associated with the Amalgamated Clothing Workers of America, first as an organizer, then assistant president and from 1966 as an international vice president. He directed the union's political and legislative activities and as head of its union label department coordinated the union's boycott campaigns.

From January 1977 until his election as IUD president, Samuel was deputy under secretary of labor, directing the U.S. Labor Department's International Labor Affairs Bureau.

Samuel has been active in politics, serving as a delegate to state and national Democratic conventions, and has served on several government commissions and on the boards of numerous community organizations. A graduate of Dartmouth College, he also co-authored two books on government.

Elmer Chatak
Secretary-Treasurer

Elected IUD secretary-treasurer in September 1979, Elmer Chatak is responsible for administering the financial affairs of the department as well as providing direction to its organizing and coordinated bargaining activities. Since 1951, he has been involved in union organizing campaigns, first on the CIO staff for five years, then with the United Steelworkers.

The USWA loaned Chatak to IUD in 1963 to serve as organizing coordinator for the Mid-Atlantic cooperative organizing campaign, directing a staff of 35 organizers from 20 unions. His win record of 153 of 197 campaigns covered 31,500 new members.

In 1968, Chatak returned to USWA to establish an organizing department and serve as the first director, a post he held until being elected IUD secretary-treasurer. During that period, about 3,000 bargaining units with over 250,000 workers were organized into the union.

Chatak was born on December 15, 1929, in Acmetonia, Pennsylvania.

For almost 30 post-war years, the American industrial worker could count on a growing economy and expanding opportunities to improve his--and increasingly her--standard of living and security on the job.

Today those dreams are shattered; the world of the American industrial worker is upside down.

There is not much need for me to report the litany of statistics testifying to our present condition. It starts with the single most convincing statistic: almost two million manufacturing jobs gone, presumably forever.

It continues with thousands of plants closed every year, with approximately 500,000 workers displaced from their jobs; with a steadily increasing trade deficit in manufacturing; with a long-term loss of market share for U.S. goods, both home and abroad.

The impact has been overwhelming on almost every manufacturing sector--on non-durables first, on durables in the smokestack industries, even on a number of high-tech sectors.

Despite this impact, I want to reassure you that American labor, by and large, has not turned its back on the need for international trade, or rejected the inevitability of global interdependence.

I don't know if the spirit of Smoot-Hawley was viable in the past; I do know it is not viable today or tomorrow.

But we also know that Adam Smith did not say the last word on the subject of international trade; that the invisible hand which is supposed to govern the free market frequently seems all thumbs; and that the recovery of the American economy cannot be predicated on some of the myths being promulgated today in the press, in academia, and even in government.

For example, there is the myth that our trade problems, resulting in our current horrendous deficit, are only temporary and will disappear when the dollar reaches a proper evaluation. Unfortunately, we can remember very clearly that the trade problem began to affect major sectors of American industry during the 1960s and 1970s, when currency was either regulated, or when the dollar was under-valued. We also know, from the report of the President's Commission of Industrial Competitiveness, that we have been losing world market share since 1965.

Second, there is the myth that the manufacturing sector really doesn't matter, that we can flourish as a service society. The result would be, of course, that we would buy our steel and autos and apparel and computers abroad, and sell our services to pay for them. The trouble is that many services are tied to goods production; if we no longer produce computer hardware, we won't be producing the soft-ware either. Secondly, major areas of services--health, education, government--are not exportable.

There is a variation on this myth, that we should give up all manufacturing except high tech. First, that doesn't leave us much; perhaps five percent of all manufacturing can be classified as high tech. Also, much of the high tech production is tied to more traditional production; for example, if Japan ends up making all our autos, they will surely also make the computers which go into them.

There is also every reason to believe that high tech is just as vulnerable as smokestack industries to the pressures of internationalization; technology is no longer a factor endowment that can give anyone a comparative advantage for more than a few weeks.

Finally, there is the myth that we've lost the ability to compete because of our high wages; all we have to do is get down to the level of our competitors and we'll conquer the world. That's almost too silly to respond to, except to note that unfortunately, we are indeed headed in that direction. Real wages have been steadily declining for more than ten years; workers are earning less today than they did in 1973, and it hasn't helped the trade balance a bit.

What does labor propose to do about all this?

As I indicated before, we are not looking back longingly to Smoot-Hawley. Blocking all trade at our borders cannot be the answer. Instead, the answer must be based on an understanding that we are facing a long-term crisis caused by long-term global changes, and that we must be prepared to develop new policies and create new structures to meet the challenge.

Part of the problems must be met through changes in the way we conduct international trade. Today we are the only major trading nation which still believes that the free market should be left completely to itself to dictate our economic behavior.

Our competitors practice an active trading policy. We prefer the passive mode. The result is that decisions made in foreign ministries of trade determine American industrial success or failure. Example: Europeans limit the imports of Japanese vehicles; the overflow inundates our market.

We are also the only major trading nation which does not bring the major players together--in our case, management, labor and government--to improve the flow of information and to design remedies for problems. We have a different system; wait until crisis hits, then respond to the political necessities. That hasn't worked very well, either.

At this point some of my listeners are going to discern signs of industrial policy and cry "foul." I plead guilty. Perhaps we'll have to change the name--I would happily accept industrial strategy, or competitiveness framework--but in the long run we must shed some of our dedication to Adam Smith and take a lesson from our successful competitors. In developing international economic policy, they long ago turned away from Smith on comparative advantage and instead adopted Clausewitz on war.

And it seems to have worked very well.

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There are similar inadequasies in our laws regarding trade disruption--the escape clause. The escape clause proceeding should provide us with the opportunity to bring labor, management and government together to develop a modernization program--so that at the end of a period of relief the industry could once again compete successfully. Such a framework does not exist today. As a result, most industries emerge from their relief period in the same condition as they entered it.

Also, our trade laws should provide for greater focus of authority within the Administration, so that enforcement is governed by a single policy, and indeed so that it would be possible for an Administration to develop a trade policy in the first place. Today our trade authority is so atomized, and so encumbered with political baggage, that we cannot produce a comprehensive trade policy—and we never have. Slogans, yes; trade policy, no.

Meeting the challenge of internationalization will require much more than changes in our trade laws. Our ability to compete is influenced much earlier, at the time a youngster drops out of high school and thereby enters the labor force--if he is lucky—without the skills needed for technological change.

It is influenced by the inability of companies, because of anti-trust constraints, to merge their research and development efforts, when it is too costly or inefficient for one company to go it alone.

It is influenced by the cost of capital in the United States, which is far higher than the cost in a number of competitors.

It is influenced by the state of our roads and bridges and transit facilities, which are slowly but surely deteriorating.

It is influenced by the insecurities of millions of workers, who are threatened by economic change and have nowhere to turn for an adequate response. An effective trade adjustment assistance program is one answer, but a far better answer would be a broad program of income supports, training and retraining programs, job counselling and job search or relocation help, which would swing into action the day the factory door closes. To make such a program effective, both labor and management agree that advance notification of layoffs or closing is a requirement. That recognition should be incorporated into law.

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We are seriously disturbed about the job loss occasioned by internationalization, and by the casual response of government to this violation of the promise of the Employment Act. I hope that these hearings help focus attention once again on that promise, and that we turn our national attention to the policies and programs needed to make it come true.

Mr. **Cahill**. Thank you, Mr. Samuel. I think you've done a beautiful job of focusing our attention on the issues.

Before we go into the questions from the audience, I'd like to have the panel focus on a point that Kevin Phillips made in his remarks but which he didn't really develop, and that is the business transfer tax, the so-called border-neutral tax that would help on the import-export issue.

I think it's important to try to assess your views on this issue because it's something that's coming up before the Senate Finance Committee this year and it's likely to be a live issue.

Mr. Vernon, I wonder if I could address this first question to you. As a member of the Harvard Business School faculty, I think you can handle it. Let's suppose that you're the chairman of the XYZ Corp. You've got subsidiaries all over the world. About half of your gross revenues come from overseas sales. The telephone rings and it's the Senate Finance Committee and they want you to come to the Hill and tell them whether you think the business transfer tax would be good for your business or bad.

What would be your answer?

Mr. **Vernon**. My answer would be that I'm unprepared to respond. I would want to know a lot more about this business transfer tax: its size, for instance, and how it would be assessed. The odds are that if it was at the modest level that is sort of consistent with the VAT concept, I would regard it as a secondary annoyance and get back to real problems.

Mr. **Cahill**. OK. Howard, would your AFL-CIO rank and filers cotton to a business transfer tax that might have an inflationary effect?

Mr. **Samuel**. I think they might have two views, depending on how it's finally developed. Union members, workers generally, have unfortunately had to carry the greatest burden of international trade and imposing what is in effect a consumer tax, which is inherently regressive, would obviously simply increase the burden.

So in that respect we wouldn't be very happy, unless the tax is crafted in such a way as to avoid the unprogressiveness of it, and I am informed that it is possible to do so.

The one thing that might attract us is, presumably this would impose an additional tax burden on imports and relieve exports of a certain tax burden, thereby putting us in about the same league as most of our trading partners. Most of them undertake the same kind of tax system and thereby gain an advantage over us.

It would be attractive if we could somehow get rid of a little bit of that handicap that we face in international trade with such a tax.

Mr. **Cahill**. We'll put you down as a maybe.

Lionel, would a business transfer tax lead to adverse retaliatory effects? Would our trading partners respond?

Mr. **Olmer**. They are hardly in a position to do that since most of them employ a value-added tax which rebates a value added on exports. But if you asked if I would approve of such a measure, I guess I'd ask the question of whether you would put me in the position of being a politician and voting on it in an election year.

Mr. **Cahill**. OK. That's a good political answer.

Let's suppose you're just a businessman or somebody who is trying to work down trade barriers.

Mr. OLMER. Well, if I were a multinational corporation I would be in favor of it, sure.

Mr. CAHILL. Why?

Mr. OLMER. Because it would make my goods more internationally competitive.

Mr. CAHILL. OK. Well, we've had three opinions. Now let's go back to the source of this proposal. Kevin, why don't you explain to the audience in a little bit more detail what your plan involves.

Mr. PHILLIPS. Well, it's not my plan or it wouldn't be getting talked about very much. It's a plan that's backed by a lot of people in the business community. It's gotten almost open endorsement from Senator Packwood. It's been sponsored by Senator Bill Roth of Delaware. I could name 10 other members of the Senate Finance Committee who are privately in favor of it. One of my publications recently took a joint poll with the Public Affairs Council of corporate government relations executives and we found that of those polled 70 percent were either in favor of moving toward a consumption tax or of opening a dialog on it.

So I think that there's a growing perception that it would serve a lot of purposes. Labor sees merit in it. Business sees merit in it. I think a lot of Republican Senators see merit in it from the standpoint of something that would simultaneously provide revenues for greasing tax reform—in essence, for sidestepping of some of the tough decisions with a little bit of lubricating revenue.

I think it has potential for deficit reduction, and I think it has potential in the trade areas as has been discussed. So I think it's starting to add up politically and I should say that I know Cambridge reports in Massachusetts has asked questions in their polls on whether people would like to tax imports and they find that they would, and Packwood, for example, discussed in an interview in U.S. News and World Report on November 18 that he thought there would be a future in a business transfer tax that was rebatable for corporations against their FICA payments so it would ease the burden on American business and maximize it on foreign business.

So I think there's a potential overlap between what Packwood has been talking about and what the Democrats have been talking about on the import surcharge. So maybe something like this will work out.

Mr. CAHILL. Are you talking about a 5-percent rate initially?

Mr. PHILLIPS. Well, I think Packwood—and I shouldn't say what he's thinking—but I have seen some references to a 5 percent and if it was rebatable against FICA a 5-percent rate would mean that a large part of the burden would fall overseas. If you had 10 percent and it wasn't rebatable against FICA, you would have a lot of American corporations and basic industries belly-up.

Mr. CAHILL. And you would exclude the retail level?

Mr. PHILLIPS. Well, all of this is being discussed by various people involved in drafting legislative ideas. Some would make exclusions. Some would not. Some would rebate. Some would not. Some would use it for deficit reduction. Some would use it for income tax bracket reduction. It comes in all flavors, like Howard Johnson's ice cream.

Mr. CAHILL. OK. Very briefly, what about the inflationary impact?

Mr. PHILLIPS. Well, the inflationary impact overseas of VAT's has been substantial within—and people disagree—some say it's within a couple of years or it depends on the phase-in time of the VAT. This isn't quite a VAT. It's hard to know exactly how much would be passed along because of the differing circumstances on the dollar and the extent to which foreign exporters into the United States might eat part of it for a while. But it clearly would have some inflationary impact.

Mr. CAHILL. OK, audience, now it's your turn. You've heard the views pro and con and in between on the business transfer tax. Now I'd like you to contribute to this discussion with a show of hands. First of all, I'll ask all those who think BTT is a good idea to raise their hands, but before you do that, the second question is how many don't think it's a good idea; and the third question is, well, maybe. So those who think it's a good idea, please raise their hands.

[Show of hands.]

Mr. CAHILL. OK. Those opposed?

[Show of hands.]

Mr. CAHILL. All right. And the last question in the middle, maybe?

[Show of hands.]

Mr. CAHILL. All right. I think we've got a poll there. It looks like—well, I'll let the panelists interpret that one. Thanks very much.

Now let's get to the real meat of this session which are the questions from the audience. We will start off with Mr. Lionel Olmer.

The first question is from Chuck Dale of the National Economist Club. When you were Under Secretary of Commerce, a major issue was the availability of funds for financing exports. Are you aware of any new ideas or techniques that businesses can use to finance exports?

Mr. OLMER. Some businesses are going to foreign banks and foreign governments to bear a share of the cost of financing exports. What happens is, in many specific examples I know—the cost of the good is not really reduced, but the way in which it's prices is. That is, the exporter gets a larger downpayment. There are not many bright ideas about how to make available low-cost capital for U.S. exporters, and I'm afraid we're likely to see that the remains of the U.S. Export-Import Bank will go by the boards in the effort to reduce the Federal budget deficit.

I have not seen any novel efforts on the part of our foreign competitors other than as I say the use of mixed credits, wherein the administration's approach has been to gain agreement through the Organization for Economic Cooperation and Development, for an elimination of such practices. To the best of my knowledge, it has not been successful and so to this day many American companies are thrust into a situation in which they are unable to compete successfully unless they have recourse to a foreign source for that capital. Some companies I know have done it with respect to Japan and others with respect to the French financing circles.

Mr. CAHILL. This is a question addressed to Raymond Vernon. Given that international coordination is needed to respond to the multinational corporation, what political mechanisms exist to translate national competitive strategies into an international strategy?

Mr. VERNON. I'm going to try to answer that question without being utterly sure that I understand what's in the mind of the questioner.

In the course of my presentation I cited four or five significant issues that I believe will be on the political agenda over the next decade or decades generated out of the multinational enterprise. They involved a wide spectrum of cases. My purpose in choosing four or five highly disparate things such as political influence, performance requirements, taxes and antitrust, was simply to underline a fundamental point that is frequently missed; and that is, that the problem of reconciling our Nation-State system with the existence of the multinational enterprise is just as complicated as the problems of business-Government relations within any single national economy. As you look at the way in which business-Government relations are handled in any national setting, there are a wide variety of institutions that get created according to the subject matter that's being dealt with. Taxes are dealt with one way; antitrust is dealt with in a totally different way; the political activities of business are dealt with in a third way; and I see no reason to expect that ultimately the international techniques that we use for dealing with the many different issues won't be just as varied as the techniques we use internally for dealing with them.

Insofar as I understand the question, I end up with a very messy answer. We are confronted with an overwhelming challenge, not just the United States but the whole community of nations, with creating a variety of institutions that are going to be forced upon us over the next decades, forced upon us by the dynamism of the business structures on which we rely. And underlying all this is the point to which I return again and again. While intellectually we are all perfectly clear on the trend that I've described, psychologically we are a thousand miles away from having accepted it. We still think of "our" business and "their" business, while the world just moves on and businessmen do what comes naturally to them.

It was only this morning in another part of town that I listened to a well-known CEO of a big oil company observing that one of his drilling platforms in the South China Sea looked as if it was going to do a critical test drill that day and he said to one of his subordinates that he would like very much to follow what happened. The subordinate said, "Well, you can direct dial the drilling platform. Here's the number." Which he did. About three-quarters of an hour after the test was done, he knew the results. This is a world we psychologically haven't adjusted to as yet. One of the major problems that confronts a committee such as the Joint Economic Committee is to recognize the structure of our basic problems over the years ahead.

Mr. **Cahill**. Thank you. A question for Mr. Samuel. Our plant is moving toward greater economic intergration among most nations. The listener must have been paying attention when Mr. Vernon spoke. Isn't it good strategy that other nations develop a greater stake in the United States?

Mr. **Samuel**. A greater stake in the United States?

Mr. **Cahill**. Yes.

Mr. **Samuel**. In other words, invest their capital in the United States? Yes, we're all for that. We like jobs. That's what people need and if the jobs are provided by capital sent in by other countries, we think that's very good, particularly since our companies are sending much of their capital abroad. The greatest irony will be some day when the American consumer has the choice of buying Japanese television sets or autos made in the United States or American television sets or autos made in Japan, and that seems to be the stage we are approaching I think in terms of what Ray Vernon has been saying.

The only caveat I would add if I could, Mr. Chairman, is that we do ask that countries coming in as our guest and taking advantage of the manifold advantages that they have here, which resolves largely around the fact that we have the largest market in the world, that they also behave as exemplary citizens—not just average everyday citizens, but exemplary citizens because they are taking advantage of something we have created. Unfortunately, some of the companies that have come here, particularly for example Kawasaki Motorcycles or BASF Chemicals—you notice I am not Japan-bashing today—BASF is from Germany—that they have behaved as if we do not have labor laws and that our workers are not entitled to collective bargaining if they wish it. Although in their own countries they do observe those labor laws, in this country, like Dr. Jekyll and Mr. Hyde, they observe a different kind of procedure.

Mr. **Cahill**. Thank you. To Kevin Phillips. If we are dependent on foreign capital to service our debt, how long can we retain our political independence as a nation?

Mr. **Phillips**. Well, I would think that the two don't necessarily go together. I mean, as long as the United States is an effective economic leader of the world to the extent that we have some more capital coming in so that a slightly higher percentage of U.S. industry is owned by foreigners, that doesn't seem to be a terrific problem.

One of the dangers might come to make a minor variation on that. I'm talking about a situation where we're having a lot of our debt financed by, say, Japan or other countries and all of a sudden you get yourself in a box where we're not free to take very substantial trade measures because if we do, the countries with which we have a major trade deficit will refuse to take their surplus and invest it in financing the U.S. budget deficit. Japan has that kind of leverage now. So I think that I'm more concerned about the extent to which we have to finance our deficit overseas with the vulnerability that entails than I am about the rising percentage of foreign ownership in a small way in some industries.

Mr. **Cahill**. OK. Thank you.

Lionel, it's your turn. A recent article in London Economist concludes that the four largest exporters of manufactured goods from Taiwan are American corporations like RCA, Westinghouse, and so forth. Why do we then blame Taiwan for our trade problems? What do you want to do with this? A similar situation exists with respect to Singapore, Brazil, and other countries, both developed and developing.

Mr. **Olmer**. I cannot recall blaming Taiwan for our trade deficit nor would I propose to do so now.

In fact, it gives me an opportunity to make a comment that I wanted to offer on the question of the composition of our trade deficit and the determination of what part of it is due to unfair trade practices. I happen to believe that a very small part of it is due to unfair trade practices and that the deficit would not be substantially reduced if all unfair trade practices were stopped tomorrow and if all foreign markets were wide open.

We have a legitimate policy concern, and that is to negotiate more liberal trade, more open markets, more reciprocal treatment for American manufacturers and providers of services, absolutely no question, and unfair trade practices should be stopped.

The problem in overemphaszing it is it avoids the more difficult question of the underlying macroeconomic factors which are responsible for a far greater share of our deficit. Tawian has been quilty of some unfair trade practices. They have not permitted some American manufacturers to sell their goods on an equitable and reciprocal basis. They do not subscribe fully to the requirements for the protection of intellectual property rights and they have resorted to counterfeiting books, records, cassettes, and so on, and some products. But the Government of Taiwan has made an effort to stop it. It ought to be encouraged and we shouldn't retaliate by shutting off imports from Taiwan.

Mr. **Cahill**. Thank you.

Here's a question that's addressed to the entire panel. If the U.S. runs a trade surplus, the rest of the world must collectively run a deficit. With every nation trying to avoid a trade deficit, is there a problem of maintaining sufficient demand on a global scale? Maybe this question ought to be addressed to the finance ministers this weekend in London. Anyway, maybe we can get some guidance for them.

Mr. **Vernon**. Well, there isn't any question but that the adjustment of the world to a shift in the U.S. balance of payments is going to be extraordinarily difficult for a number of different countries. The general assumption is, of course, that among the various countries that will be in a position to absorb this adjustment are notably Japan and Germany.

A critical question is how current account deficits are in the end financed. If the effect of the U.S. shifting its position in world trade is in part for Americans to resume the export of a capital to the developing world, for example, you could very well picture that the adjustment would be accompanied not only by sustained demand in the world but even by increased demand from such countries.

The redistribution of the surpluses and deficits by itself tells you very little about the aggregate demand in the world, unless you puzzle through the significance of the intervening variable, the shifts in saving, in investment, and in world demand. There are some models which, if they can be believed, have you coming home free, home free in the sense that the patterns that emerge after the adjustment are quite consistent with a resumption of growth in the world. It doesn't have to come out that way. It might come out disastrously if the redistribution of balances takes place in a destructive way, so you have another source of uncertainty here.

Mr. CAHILL. I'm told by the staff that we're running out of time. Is there anyone on the panel who wants to elaborate on that question? If not, before we sign off, I would like to bring you up to date on the poll we took on Kevin's BTT. I think in fairness to Kevin and to those in the television audience who didn't have a chance to witness your show of hands, the results were that a few thought the idea was a good one, a few thought it wasn't such a good idea, more than a few thought it was worth exploring, and the vast majority had [illegible] comment. This must be an audience of economists.

The last question. Most U.S. exports operate with Fortune 500 companies, medium- or small-sized firms don't participate to any great extent. What additional steps can we take to make the smaller firms more export conscious?

Mr. OLMER. Well, it's one that the Commerce Department and others in governments present and past have wrestled with, but it is a distortion. For example, there are many thousands of small- and medium-sized companies that serve Fortune 500 companies in terms of providing them with components in the process of manufacturing a final product for export. Such is the case in the aerospace industry, one example being, I am told, the Boeing 747 has in the order of 3,000-plus suppliers that relate to the production of that aircraft.

In terms of heightening consciousness, I think that for purposes of dealing with a $140 to $150 billion trade deficit and the urgency of getting the U.S. manufacturing community capable of bringing it down, there is no substitute for increasing the competitiveness of the large corporations, like it or not, in the short term. That's all we are faced with the opportunity for doing.

Mr. CAHILL. Thank you. We have a small ream of questions that we haven't been able to get to which I think is a tribute to the panel and also to the very receptive audience. Thank you very much and thank you, Chairman Obey.

[Applause.]

Chairman OBEY. We will continue with the next panel immediately without the break announced in the program to try to remain on schedule. So if I could ask the next panel to please come up and everyone to resume sitting as soon as possible.

One economist, Dale Jorgensen, has calculated that nearly one-third of our annual economic growth between 1948 and 1973 can be directly attributable to labor inputs. Nonetheless, we have the tendency to concentrate much of our attention on capital and technology inputs to growth because they seem to be so much easier to quantify.

Investments needed to ensure that our labor input is of the quality to generate growth is a very complex question, as I'm sure you understand.

The quality of our work force is dependent upon human traits as well which are impossible to quantify such as drive, attention to detail, instinctive anticipation of future problems, and sometimes just plain common sense and guts.

We do know that these characteristics can be enhanced and developed by study and by learning, but to facilitate that we are dependent to a very large extent upon public, private and industrial education and training institutions to perform the systematic function of education that we need.

Last fall, Peter Drucker wrote in the Wall Street Journal that the only competitive advantage that the United States can have is to make productive its one abundant resource, which is people, with the years of schooling suitable for white collar jobs. Therefore, we have to expand our prevalent view in policy circles that learning is a task primarily for the young and seriously consider how to upgrade our existing work force.

There are many other questions we have to face as well ironically, I guess I would add that one of the strange things is that in the task of doing this we are relying upon a group of professionals who, in my judgment, are significantly underpaid themselves.

This panel will address that problem today and the moderator for the panel is Mr. Steve Nordlinger, who is a veteran reporter for the Baltimore Sun, who is one of the best reporters on economics statistics because of his long career covering the economics beat. Steve, it's all yours.

PANEL: CREATING A WORLD-CLASS WORK FORCE—STEVE NORDLINGER, MODERATOR

Mr. NORDLINGER. Thank you very much, Mr. Obey.

This afternoon we have four panelists and I will call on them in order, Pat Choate, who is the director of the office of policy analysis for TRW Inc. He has also served as Director of the Office of Economic Research in the Economic Development Administration.

PRESENTATION OF PAT CHOATE

Mr. CHOATE. Thank you very much, Steve, Members of the Congress, ladies and gentleman.

Jerry Jasinowski began his talk earlier today with a quote from Calvin Coolidge. I think I'd like to draw on a couple of characters from that era, Damon Runyon and Mae West, as an opening line to begin my talk.

Damon Runyon once made the observation about a race track tout who noted that the race may not belong to the swift or to the strong, but that's how you'd better bet your money. And Mae West said, "If it's worth doing well, it's worth doing slowly."

So in a sense, what I would like to talk about is why Mae West was wrong and why Damon Runyon was correct, why in effect the world class work force is truly one that is strong and swift, strong in the sense that it has state-of-the-art education and skills, that it has the assurance that it can modernize those skills throughout their working career, and swift in the sense that they are adaptable, that they are unafraid of change, that they can move between occupations and jobs and regions and do it quickly and do it well.

That is ultimately the basic necessity of creating a world class work force.

Fortunately, America has most of what it requires to keep a world class work force. We have created over many decades a marvelous system of educational facilities, vocational schools, technical colleges, community institutes, higher educational facilities. We created 50 years ago an employment security system that has the responsibility to operate a labor market information exchange system. We have a tradition of training among American corporations. American corporations today under various estimates spend over $30 billion a year in formal training. These are formidable assets.

But to meet the swift challenges that we face in the global economy this may not be enough to have a truly world class work force in the year ahead. There are some changes I believe that we need to make.

The first is going to be a change in attitude. We are I believe in a very different era in the late 1980's and 1990's simply because of the demography of our work force. We have a generation of employers that have gained their experiences in an environment in which there's been a labor surplus, in which there's been a massive influx into the marketplace of the baby boom generation and over the past really four decades increasing numbers of women—a great cultural revolution.

That is coming to an end. I think many demographers make a very persuasive—at least it persuades me—that we are coming to a point in the 1980's where we may actually have labor shortages. Certainly it's true we're going to have an older work force. It's true that by 1990 about 55 percent of our work force will be in the age bracket of 24 to 55 years of age. What that means very simply for employers is increasingly the attitude shift that will be required is that they must in fact make their own skilled workers rather than simply depend on the possibility of just going out and buying those workers off a marketplace with a large influx of workers. It means increasingly employers are going to have to assume a responsibility to in effect train their own workers, take those workers that they have and upgrade their skills. This is particularly important because with the maturation of the baby boom generation, 86 percent of the people that will be in the work force in the year 2001 are already adults and most are at work. In effect, tomorrow's workers are those who are working today.

How well, how quickly we can assist those workers to make the adaptations that they face is going to determine how well and how quickly that our economy makes the necessary adaptation that it must.

Equally important, I think we must recognize that many of the institutions on which we depend on a swift and strong world class work force are today not meeting the types of standards I think most of us would wish that they do.

Employment Security Office, for example, the labor market exchange system, only half the States at this point have computerized the 2,000-plus offices that exist across this country. We wind up with only really about 7 percent of our employers who even use the system. Most of the jobs that they do offer are jobs that are at the lower end of the scale. There's a very ineffective exchange of information between the States as to job openings.

In fact, one measure of how ineffective it is is it's still done by which the States collect the data, put it on microfiche, mail it to Albany, NY where it's resorted and they remail it back out. We can do better than that as a society and people. We're talking about very common off-the-shelf technology.

Another major training challenge that we face in this country is that of how do we deal with the displaced worker issue. The Bureau of Labor Statistics indicates in a study that they did that between 1979 and 1984, 2 million workers a year became unemployed because their jobs had disappeared. A million a year of those workers had been on the job for 3 years or longer.

Everything that I see suggests that the processes of change, the creative destruction that Joseph Schumpeter spoke about 40 years ago, are accelerating. I see every indication that America will have high displacement as a natural course of economic change for the foreseeable future.

Yet, our programs to assist workers at the Federal level are an ineffective maze of 22 displaced worker programs that are dependent upon the annual Federal budget cycle and that cycle is precarious indeed, as I think most of us are aware.

A few progressive companies, a few progressive unions, have engaged in programs such as the Ford Motor Co., and the UAW and AT&T and the communications workers, but they are a rarity.

And even more important, if all union workers were covered, it still leaves 82 percent of our work force who are non-unionized.

We require I believe a comprehensive worker adjustment program that will assure workers that throughout their career, with all of the processes of change, that there are the means available for them to be able to secure the training, the counseling, the testing, the information about jobs, so that they may make the adjustments that they require.

And then finally, because the average age of Americans is over 30 years, because most of our work force is entering their 30's, they are in effect becoming middle-age workers, the time I believe has now come to recognize that most of those workers will soon be thinking about their retirement and yet I think most of those workers when they think about that realize that the pension programs that exist today really do not guarantee them a long-term security that they are going to require.

My argument is that the time has probably come in America to find the ways and means to tie pensions to the workers and not to the jobs. The time has come I believe to create a truly portable personal pension systems that workers can have the assurance that throughout their working careers they will be able to move from job to job, from occupation to occupation, and at all times be able to build into a fund that will assure them a sound, dignified retirement.

So, in sum, what I am suggesting is that in the changing world in which we see technology may shift and move across borders, capital certainly can move and shift across borders. Our workers have much less flexibility to make those changes.

If our economy is to maintain productivity and the competitiveness which we require, and if we are to keep the capital and technology here, the quality of the work force performance, having a world class work force, is going to be essential to that objective, to that task. Most of the institutions required to create a world class work force exist. Most work well. There are additional things, however, that we must do.

I would suggest how well we do them will in large measure determine how well we meet the changes of the quick shift in the future. Thank you.

Mr. NORDLINGER. Thank you very much, Pat.

Our next speaker is Denis Doyle, resident fellow in education and director of education policy studies at the American Enterprise Institute. He has also served as Director of Planning and Program Coordination for the U.S. Department of Education and as Assistant Director for Education Finance at the National Institute of Education.

PRESENTATION OF DENIS P. DOYLE

Mr. DOYLE. Steve and Members of Congress and fellow panelists, thank you. It's a great pleasure to be here. I worked my way through college at the business end of a pick and shovel and my first white collar job was in this building working for Jeff Cohalen a Member of Congress from Berkeley and I never in my wildest imaginings thought I would be on this side of the dais, so it's a special pleasure to be here.

Let me put your minds at ease on a balmy Friday afternoon. First of all, I'm not an economist and, second of all, I will be mercifully brief. I'm reminded of a favorite story which I think is appropriate to this audience. Al Smith, an indefatigable campaigner, made his way to the podium one afternoon after a long day on the campaign trail and as he was about to speak someone in the far back of the room pulled himself to his feet and said, "Tell them all you know, Al. It won't take long." He said, "I'll tell them all we both know and it won't take any longer." So I'll tell you all I know and I'll be brief.

It seems to me that my interest in education and politics and economics is appropriate conceptually for the reason that politics has become the principal vehicle for distributing the scarce goods and services we associate with education. At the elementary and secondary level, 90 percent of our children attend public school, and the queues that are established for schooling, the access to schooling, and the quality of that schooling, is decided through the political process.

And second, human capital, that much overworked term, insofar as it has public policy meaning, has meaning as we understand the education system. Certainly culture, history, family, tradition, even religion, play an important role in human capital formation, but the public institution that most shapes the quality of our workforce is our schools.

The question then, "does education make a difference" is the question before us. I think it can only be answered in a ringing affirmative, yes, it does; and education can in fact help materially to create a world class workforce.

Now if we are unable to demonstrate that to the satisfaction of professional economists, I would suggest that points to flawed methodology, not a flawed conclusion.

Now how do we know this? I would suggest two streams of analysis. One is the tried and true approach which is to look at the competition and what do they do. The competition which you are all tired of hearing about, of course, is the Japanese. What they do in the way of schooling is remarkable. They have the world's most completely and best trained workforce, one of the best workforces in terms of mature industrial technologies. Now what do they do in 240 days of school per year—they study longer. They go to private school after public school. They have to do homework. You've heard of Jewish mothers. Well, Japanese mothers make them pale into insignificant ones. They work and labor with their children and with the schools.

Japanese high school graduation rates stand at about 98 percent. Ours have fallen to about 72 percent. The typical Japanese 18-year-old has completed the equivalent of about 2 years of a good American college.

Japanese measured IQ appears to have climbed by 7 to 10 points over the past two decades. The Japanese rely upon tests and measures and they have a curriculum-centered school in which the child is expected to measure up to the demands that the school places upon him.

Now this is not simply an axiomatic outcome of Japanese culture, history, and tradition; but rather, the product of a set of deliberate Government policy choices made by the Japanese people.

First and perhaps most dramatic was after the Meiji restoration in the 1870's. The Japanese were determined to enter the modern world. They were determined to preserve their cultural distinctiveness and at the same time borrow from the West, as they have become past masters at doing.

To do so, they invited a group of American education consultants to Japan who, after careful deliberation and consideration, proposed to the Japanese that they create a system of what we would now call grammar school in the English sense: fast-track, demanding, academic schools, for the elite. They were selective, hard to get in, and harder to stay in. That served the Japanese very well until the Second World War when General MacArthur—in charge of the occupation—determined that all things Japanese should be democratized.

The Japanese agreed, with some reluctance in one case; education was subject to one proviso and one proviso only; their standards would not be lowered. The Japanese have literally pulled the bottom up to the top; the evidence is that the Japanese test scores are the highest in the world by any measure, and they cluster around the mean. There are very few outlyers in Japan. Japanese students across the board do extraordinarily well.

Now the third wave of Japanese reform is being put in place right now by Nakasone and that, too, looks to America for habits of innovation, for creativity, for intellectual creativity in addition to the intellectual discipline they have so carefully inculcated in their people.

I belabor the Japanese example not to suggest that we would or should slavishly copy them. That would be inappropriate and wouldn't work. But one thing we can learn from the Japanese and that is that our schools can serve our public policy objectives and they can serve them well and serve them efficiently.

Now if we look at home, I think the evidence is also conclusive. Unfortunately, it seems to be negative. We watched a two-decade collapse in test scores, and not just a decline on average SAT scores, verbal and mathematics scores, but a very real decline, a measured decline in the number of young people who are high scorers in both the mathematics and verbal portions.

It's not a matter of a few kids or even a large number of kids getting lazier. It's a matter of a whole generation scoring less well.

Now if one sorts through the evidence and looks at all the possible variables to explain why this decline occurred, only one variable really stands out. It is what Barbara Lerner called "the hard work" variable. American young people have not worked hard enough. Not enough has been expected of them. There has been a massive shift to what we call the general curriculum—journalism instead of English, art appreciation rather than art, driver education in California demands more public resources than reading instruction does in high school. Now it may be that it's more important to be able to drive in California than to read, but that offers slender solace we think about a world class economy.

You can take you choice as to what variable you want to assign to account for this decline in the hard work variable—TV, Vietnam, permissiveness, broken homes—certainly they all play a part. But nevertheless, taken together, it is clear that too little is expected of our students and too little as a consequence is produced by them.

The problem, then, is precisely what the excellence movement has said it is, whether it's the President's Excellence Commission Report, the report of the Education Commission of the State, the report of the 20th Century Fund, reports too numerous to catalog here today. Standards have not been set; as a consequence, nor have they been met. The "high demand" curriculums we had come to expect until about 1960 has virtually evaporated. It is, for instance, possible to graduate from a post-graduate program in this country never having studied a second language. Tests and measures in this country are not content-based. They are tests and measures with very little meaning. Demanding textbooks have virtually disappeared. One of the principal problems is that high school teachers and high schools with high standards today face the almost complete lack of availability of "high demand" textbooks.

Homework, probably the single most important variable in student performance, has virtually disappeared, and it is shocking, but sad to say, true, that we need research to prove this obvious homespun observation, but we have learned through painful research that homework which is assigned, completed by students, returned by the student to the teacher, graded by the teacher and then returned to the student, does, in fact, make a very real difference.

Other simple things also make a very real difference. Parent involvement, for example. Not parent involvement with the school, parent involvement with the child. Children who are straight A students report overwhelmingly, almost unanimously, that their parents know where they are, what they're doing, what the school expects of them, and what they are doing to meet those expectations. And the scale slides downward, as one would expect. F students report that their parents neither know nor care.

Now as it happens, almost none of these attributes, none of these activities, are suited to public policy intervention in any direct way in a democracy. Public policy in a democracy can very efficiently, raise barriers. We're familiar with the legacy of Jim Crow, in which barriers were efficiently raised against racial minorities. We're familiar with the great success of the civil rights movement in demolishing those barriers. But having demolished them, public policy is a blunt instrument, in terms of creating an environment in which young people can capitalize on programs and opportunities.

If this is the case, are there program strategies that can be devised that will remedy these problems? My answer is "perhaps" because the response to these problems falls across two broad bands.

One I characterize as the visible curriculum; it includes our cultural patrimony, knowledge of math, science, art, music, history, literature. It's what students study whether or not they master it.

Second, there is the invisible curriculum. Attitude toward self, toward fellows, attitudes toward work. Simple things like punctuality, reliability, honesty, self-respect; and at a more elevated level, a commitment to civic virtue.

These attributes are acquired by example and practice, not by didactic measures. Imagine, for example, a class in punctuality. No one who needed it would come on time.

How do you strengthen the visible and invisible curriculums? I would suggest, in a postindustrial society, that we are also in a postprogram society. The passion for input-based programs, counting numbers, things, people, books, hours, minute and days, must give way to an equal commitment to performance-based programs. And we must—public and policymakers alike—gain some insight into the value added by education. Only then can meaningful accountability be created.

By way of illustration, let me close with two simple examples. They're homespun, but I think they will work. One is the concept of intellectual or academic bankruptcy. Schools which fail to meet their obligations to their students can be put into receivership. And similarly, schools which do meet their obligations to their students can be declared, by the tried and true principle of managment by exception, to be schools left to their own devices to satisfy the claims their constituents have on them and to meet their obligations to their students.

In summary, I see a fairly interventionist and activist State role. I see a limited and truncated Federal role, by the nature of the problems that we confront. On balance, I am convinced, however, that the world class economy is within our reach, that it can be done in large measure through public elementary and secondary education, and it is with the capacity of State policymakers to make the decisions that will make it come to pass.

[The complete presentation of Mr. Doyle follows:]

STATE AND FEDERAL STRATEGIES TO IMPROVE THE QUALITY OF THE AMERICAN WORKFORCE

A Paper Prepared for the
Joint Economic Committee on the
Occasion of Its Fortieth Anniversary

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The views expressed here are those of the author and do not necessarily reflect the opinions of the staff of the American Enterprise Institute or its trustees.

INTRODUCTION

This essay provides a preliminary examination of education strategies that might be employed at the state and federal level "to improve the quality of the American workforce" as we look toward the 21st Century. The scope of the question is, of course, daunting, even presumptuous. But to fail to try to answer it courts disaster.

If we have learned anything from contemporary economic theory it is that human capital makes a difference. The quality of the workforce is the sine qua non of economic vitality and competitiveness. It is by now a cliche but it bears repeating: a nation's greatest natural resource is its people.

The knowledge that human capital is important, even cental to economic well being in the modern world, is not the same as knowing what to do about it. How is human capital created? What incentives and disincentives in both the public and private sector encourage or discourage its formation? And of those incentives that work, which are most cost effective?

These are not idle questions, because if we have learned anything from the New Deal and the Great Society it is that we must use applied intelligence to plan for the future: it will not take care of itself. But we have also learned--or one hopes we have--that even if we set our sights high, our implementation goals must be modest and realistic. It serves no one's purpose to promise more than can be delivered.

The question before us, then, as Harvard's James Q. Wilson observes in the twentieth anniversary issue of the Public Interest, must always be "what works?" Of necessity answers must be provisional, even tentative, because what works today is almost certain not to work tomorrow. This is so because "objective conditions" continuously change. But it is also true because we view the future through a glass darkly. As a consequence, in public policy an iron law of "unforeseen consequences" is everywhere and always at work. We have learned from hard and sometimes bitter experience that our best laid plans are without exception beset with unforeseen (and perhaps unforeseeable) consequences. Unanticipated consequences are not always bad, but they are rarely uniformly good. And they are almost always perverse.

This is so far the best of reasons. Public policy is not about annointing winners--they take care of themselves--it is about solving those sticky problems that do not spontaneously go away. Public policy nostrums are typically directed at those who are worst off: as a consequence public policy benefits are reaped by those who are--or seem to be--in trouble. Whatever we subsidize we get more of--that is a subsidy's purpose--and so it is with public policy.

By way of illustration, it is worth remembering that when the floor debates were held in the depths of the Depression on the Social Security Bill the only part of the legislative package that was wholly noncontroversial was aid to widows and orphans. Today, of course, AFDC is the only part of the original package that is controversial. And what is true of social security is true of domestic social policy generally; it is a mine field of unintended consequences and perverse incentives, few of which work as intended.

What has this to do with the question at hand? First, it should serve as a constant reminder to be modest in ambition and expectation; it should also remind us that the kinds of solutions crafted during the New Deal and Great Society are not likely to work in the future. Indeed, if we have learned anything it is that those programs that really "work," work with a vengeance. Social security is out of control because it works too well. Who can gainsay its success? And who can bring the program to heel? That public policy bolt has been shot home. We can learn from the programs of the past, but must not repeat them.

If we should be skeptical about our ability to solve major social problems, so too should we be skeptical about our ability to even frame the questions. "The quality of the workforce" is an umbrella that covers a set of questions so complex that they are difficult to disentangle. "The quality of the workforce" is clearly not easily measured except in the grossest way, as human capital economists and analysts have discovered. Analytically we can note, as Nobel Laureate Theodore Schultz does in Investing in People, that the idea of a "quality workforce" falls across two broad fronts, health and developed human intellect. A sickly workforce is by definition of low quality, but a healthy one may only be possessed of "latent" high quality. It must be able to take advantage of its good fortune. To be of "high quality" then, a workforce must as well possess knowledge, skills, and attitudes toward work that permit it to fully exploit its potential. (For a more complete discussion of this subject, see Denis P. Doyle, Foreign Policy and Defense Review, American Enterprise Institute, Vol. 5, 1985.)

It is clear that workforce quality is a product of many factors--culture, history, family, church, and school--which may be analytically distinct but which are woven together. But it is also clear that public policy can not retrospectively change a people's history and our understanding of how it might change cultural attitudes is dim at best. One thing public policy can do, however, is to direct its attention to those social institutions which are amenable to public policy intervention; in the case of workforce quality that institution is the public school. This essay limits itself to that aspect of workforce quality. It assumes our knowledge is limited but that we must still make decisions. That decisions must be made in conditions of uncertainty simply means that we must be prepared to revise our thinking when new knowledge or more powerful analytic tools are at our disposal.

What, then, do we know about "workforce quality?" What are its constituent parts? Of what is it comprised? And what dimensions of "workforce quality" are susceptible to public policy invention? Which variables in the public policy equation are subject to manipulation?

THE COMPETITION

To begin to think about this in a systematic way, it is useful to turn to the competition. What does their workforce look like and why? In this case, of course, the competition is the Japanese--no other competitor is so effective and so threatens American economic preeminence. Japanese economic success is built on extraordinarily high levels of product design and manufacture, as well as distribution and marketing. Japanese products are handsome, rarely break or fail, and are widely available. Sony and Seiko are two of the more well known product lines; most important in these examples is that they also command premium prices. They are more expensive than their American or European competition, and sell well because of their demonstrated quality. Not long ago Japanese products were regarded as inferior junk; today they lead the world. Such a development is not accidental. What accounts for it? The quality of the workforce. It is the best in the world. Why?

It is the best educated workforce in the world. (While the relationship between education and productivity is not as easy to demonstrate empirically as one might expect intuitively, the difficulty of the demonstration says more about the limitations of methodology than the correctness or lack of correctness of the inference.)

Japanese education at the elementary and secondary level is without peer in the world, as a number of careful observers have noted. (See Sam Nakagama, Kidder, Peabody; Merri White, The Public Interest; Barbara Lerner, The Public Interest). The typical Japanese 18 year old has completed the equivalent of two years at a good American College. Not only does the typical Japanese youngster attend school 240 days per year--in contrast to his American counterpart who attends 180 days per year--the Japanese student studies harder. He does substantially more homework and typically will enroll in a private supplementary school or Juku to prepare him for the inevitable examinations that characterize every phase of Japanese school life. Also in sharp contrast to his American counterpart, the Japanese student is much more likely to graduate from high school, even though compulsory attendance ends at age 16 (as it does in most of the United States). Seventy-two percent of American youngsters graduate from high school, while 98 percent of Japanese youngsters do. Even more startling, the American graduation rate has fallen over the past decade, just as academic standards were falling. In other words, as high school got easier, fewer American teenagers decided to earn a high school diploma.

As if this were not enough, over the past decade and a half Japanese IQ is reported to have climbed by 7 to 10 points. In addition, Japanese education is not simply mindless rote memorization (although in that it does abound); Japanese schools stress team work, cooperation, self help and school service. Even the youngest children in the early grades help keep their school building clean and neat. Such a system, is of course, supported by Japanese families and the larger Japanese culture. How could it be otherwise? Japanese mothers are virtually partners with the school. They hover over their youngsters, making sure that they have a pleasant environment in which to do homework, and also make sure they do it.

How did this come to pass? Is it all an accident of Japanese culture and history? Not in any axiomatic sense. Japanese schools are the result of deliberate policy choices made by the Japanese government. Japanese schools are a product of two waves of reform. The first was in the 1870s after the Mejei Restoration. Determined to Westernize as rapidly as possible--without losing their cultural distinctiveness--the Japanese turned to a small coterie of American consultants to help design a modern school system. The advice was to create an elite system of schools modeled on the demanding, academic high school of New England. This the Japanese did with a vengeance. The Japanese schools of the late nineteenth and early and mid-twentieth century were selective, elite, and demanding.

After the Second World War, the Japanese were instructed by MacArthur to democratize in all ways, including their schools. This too they did, subject to one proviso--they would not lower their standards.

The Japanese example is not something to be slavishly copied but I belabor it for two reasons: it is an example of people deliberately designing a public institution to serve clearly specified public purposes. And two, American business men familiar with Japan believe that Japanese education is the key variable that explains Japanese economic productivity. (See, for example, Investing in Our Children: Business and the Schools, a policy statement of the Committee for Economic Development, which I co-directed and wrote. The policy statement was released September 5, 1985. For the more academically inclined, Barbara Lerner's analytic tour de force (George Mason Review) ties together school outcome data and productivity data. She finds what one would expect. The two are intimately related, and high levels of academic attainment across the board shows up in high levels of economic productivity.)

It is important to note that the Japanese education system appears to foster intellectual discipline rather than intellectual creativity, and by its own admission, has serious problems. No one is more keenly aware of this than the Japanese and they are today engaged in a third wave of reform: they hope to introduce another element of American education which is central to the knowledge based economy: creativity, spontaneity and inventiveness. But even with its limitation the Japanese education system is ideally suited to mature production technologies, and it has served the Japanese well. It is certain that the Japanese will take the necessary steps to modernize their education system to reflect the needs of the post-industrial, knowledge-based economy of the future.

Taken in its entirety, then, what does the Japanese system tell us about "workforce quality?" If anyone is still in doubt, it reminds us that the single most important public policy variable that determines the quality of the workforce is the quality of the education received by the workforce. As well it suggests that the ways in which education is delivered makes a difference. Schools with very high standards, schools that expect everyone to learn, teach lessons that carry over into the work place.

There is more to this point than meets the eye, particularly to noneducators. Most laymen take for granted the straightforward idea that some schools are better than others, and all things being equal, it is better to attend a good school than a mediocre one. But this homespun insight has been lost on many educators: they believed that all schools were the same and what differed was the raw material. Like the southern governor who argued his prisons couldn't be improved without a better class of prisoner, educators said--or implied--that their schools could be no better than their students. Although such ideas seem errant nonsense to non-educators, for more than a decade they seemed to be cloaked in academic respectibility.

The pernicious idea that "schools don't make a difference" had gained currency because of careless reading of James Coleman's famous report to the Congress, Equality of Educational Opportunity (1966). It was interpreted to mean that student outcomes were not affected by differences among schools. Differences among students--race, ethnicity, social class, parental education explained them. Admittedly, these variables make a difference, but so too do schools. As revealed in Coleman's High School Achievement, Andrew Greeley's study, Catholic High School and Minority Students, and Michael Rutter's Fifteen Thousand Hours, what schools do does make a difference. Indeed, what they do--or don't do--can make a very big difference, particularly with disadvantaged youngsters.

AMERICAN BUSINESS AND THE SCHOOLS

If the Japanese experience provides insights into the question of education strategies that affect workforce quality, what do we know closer to home? What do America's major employers think about strategies to improve the quality of the workforce? As it happens, a good deal, and it is based on a thorough and careful study conducted by the Committee for Economic Development, cited earlier. (See Investing in Our Children: Business and the Public Schools. The Committee for Economic Development is made up of over two hundred trustees, most of whom are the chief executive officers of America's largest corporations. A smaller number of trustees are presidents of the nation's most distinguished colleges and universities.)

It is based not only on the substantial experience of the trustees, but commissioned analyses and a major survey of employers and postsecondary institutions. (The survey went to 500 large corporations, 8,000 small businesses and 600 post secondary institutions, ranging from small proprietary schools to Ivy League colleges.)

The survey found two things, regardless of respondent: large companies, small businesses, major research universities and small proprietary schools look for the same thing in high school graduates: the capacity to continue learning and a positive attitude toward work. The second finding is hardly surprising, but to many the first was. Businesses report that they need employees who are problem solvers, self-starters who can think critically and independently. They are not looking for narrowly trained workers. They are, in fact, disdainful of much vocational education. And they are convinced that any vocational education should be undergirded by a sound academic education. Indeed, modern corporations are prepared to provide substantial amounts of training so long as the employees are trainable.

The qualities employers report that they look for are precisely the qualities that permit individuals to seek and find satisfying work, as distinct from the dead end employment frequently associated with vocational education. It is noteworthy that the willingness of employers to provide training reflects the realities of the modern economy; it is not altruism. Today few job descriptions are permanent; insofar as a job may be permanent, it is a function of the employee's ability to acquire new skills on the job. For the employer, then, training is a cost of production, in just the way product development, marketing and research are. Today's new employee can expect to hold three to five different jobs over his work life. Employees, then, need a broad, liberal education to prepare them for tomorrow's economy.

For the most pragmatic of reasons, business, expects the schools to produce literate and academically well grounded graduates, young people who have acquired what the Council for Basic Education calls the "generative skills," the real basics on which further learning is based.

As the past two decades have revealed, however, this is a tall order. Explanations for the decline in test scores--particularly the Scholastic Aptitude Test (SAT)--are numerous, but when the smoke and fog clear they are reduced to one: as Barbara Lerner so aptly observes, the decline in test scores is explained by the decline in the "hard work variable." Students who work harder do better, just as workers who work harder do better. Japanese students certainly do.

If the quality of the workforce, then, depends on the quality of the education workers receive before they enter the workforce and the attitude toward work they carry with them, what are the implications for the schools? The implications are surprisingly simple and straightforward, and are embodied in what I have chosen to call the visible and the invisible curriculums.

The visible curriculum is simply what is taught and what it is students are expected to master. The visible curriculum is not fixed; it can include many subjects so long as they are studied seriously, with rigor. Mastery must be demonstrated both as study progresses and as a condition of graduation or matriculation. Thus, the visible curriculum--at least in theory--could be the "classical curriculum" of the Middle Ages, the Trivium. Quadrivium, or it could be auto shop. (For an elegant exposition, see Dorothy Sayers, The Lost Tools of Learning.) In either case, the sine qua non is rigor, mastering a complex and demanding body of knowledge.

By way of illustration, the visible curriculum could require mastery of a second language--any second language; the discipline

necessary to master a second, and the insight such mastery provides, pays handsome dividends in terms of intellectual development and readiness to learn other things.

As a practical matter, the visible curriculum cannot include just anything; Sanskrit is not as useful as German, the history of Patagonia is of less relevance to Americans than the history of the U.S., and Shakespeare is to be preferred to studying journalism. As a practical matter it would not be just anything; responsible parents, teachers, administrators, trustees and the like should see to that. If they do not, state policy makers should.

What then, should it be? If we are serious about a high quality workforce for the next century, such a curriculum must be what we used to think of as a liberal arts curriculum, a course of study in which our cultural patrimony is passed from one generation to the next. The issue is not just knowing how to read, but what is read. It must inculcate the set of skills that will be essential to gainful and satisfying employment for the rest of this century and the next. It must teach students how to think, to problem solve, but these skills are not transferred from teacher to student by didactic means. Students do not need to take courses in how to think. Rather, they must take substantive courses in which one must think to understand--people learn to think by thinking and thinking hard. In school, then, this translates into mathematical problem sets, understanding fundamental scientific concepts, knowledge of literature, history, and philosophy, as well as writing assignments. It should include poetry as well as expository prose, essays and creative writing as well as research papers, studio art as well as appreciation, school and community service not just lip service. It means homework that is assigned, returned, read, marked and returned to the student. It means tests and measures with teeth in them, for both teachers and students. It means family involvement, in which the school can expect the family to back it up. It means parent involvement in which the parent can expect certain things of the schools. Finally, it means a diploma which itself means something, not a piece of paper which simply attests that the student spent twelve years in and around a school building.

In short, the visible curriculum looks like the course of study already offered at the Bronx School of Science, Boston Latin, Philadelphia Central, Palo Alto High School, New Trier and dozens of other first-rate schools across the country. To think schools like this--and the curriculum they employ--is just for the best and brightest is the worst kind of elitism. The Japanese didn't think so in 1945; their confidence that all children can measure up is paying handsome dividends.

What of the invisible curriculum? Of what does it consist and how does it relate to the visible curriculum?

In a word, the invisible curriculum is the values and attitudes communicated by the school. It is, of course, a truism that schools cannot be value free. They stand for something--intellectual standards, fidelity, hard work, merit, self respect. If they are indifferent or remain silent, they can stand for negative values--low standards, lack of respect for others, a willingness to tolerate shoddiness, even contempt for excellence.

Not surprisingly, the traditional values associated with a workforce of high quality are the same values associated with academic accomplishment: self discipline, high standards, respect for others, reliability, punctuality, and honesty. These values are transmitted in the first instance by family and the larger culture; but they must be reinforced by the school or the school loses its legitimacy. The most important ways these values are transmitted, however, are by example and practice. They are only occasionally transmitted--if at all--didactically. Pious homilies are not the answer. No one takes a course in punctuality; if the student needed one, he would be unfailingly late.

By example I mean teachers and administrators who are proud of their calling, take it seriously, and communicate their seriousness of purpose to their students. By practice I mean habits of mind cultivated by work and repetition. This formulation is no more and no less that of Aristotle's: virtue is acquired by behaving virtuously.

Schools then must set simple standards: work must be completed neatly and on time. A failure to do so gives the student precisely the wrong message. At higher levels, schools should require school and even community service as a condition of graduation. Education requires giving as well as receiving.

If a reinvigorated visible and invisible curriculum are needed to build a workforce of high quality, how might they be secured? Are there a set of programs waiting to be designed and put in place that will solve the problem? Not likely, because the issues they raise do not lend themselves to conventional programmatic and bureaucratic intervention. Questions of student performance, tests and measures, the quality of textbooks, the condition of work of teachers, who enters teaching and teacher training programs, how much homework is assigned, and the like are not issues effectively addressed by the policy tools of the past. The issue is important because the temptation to try to design and implement programs to solve perceived problems is almost irresistible.

Not only are members of Congress enamored of programs, state legislators and governors in particular are susceptible to the blandishments of program designers. As the public officials most responsible for the health and well being of the public schools, their eagerness to repair them is understandable. So too is their choice of policy tools--programs and the money to underwrite them. That, after all, is what legislators and governors do best: legislate and administer with a mix of edicts and dollars. But it is not at all clear that these responses have much relevance to the problems we now face.

THE LIMITS OF PROGRAMS

Since the New Deal, federal and state domestic policies have been the product of an obsession with "programs;" programs to heal the sick, clothe the naked, house the homeless, feed the hungry, educate the uninformed, train the unskilled. Programs to transfer income from one generation to another, from one segment of the economy to another, from one region to another, from one subset of the population to another. In some real measure, preoccupation with "programs" was both sensible and appropriate: for many Americans, they worked very well. But it is now clear that they do not work well for all Americans. They have become complex, inefficient and often misguided. That this has occurred should be no surprise. Programs of necessity are broadly gauged, bureaucratic exercises designed to reach an eligible population targeted for reasons of public policy--the aged, or ill, or poor, or disadvantaged, for example. By virtue of the requirement that they serve all equally, the capacity of programs to discriminate or fine tune is severely limited. Eligibility for program coverage is typically a state of relative deprivation as defined by program architecture; if that relative deprivation is corrected, the recipient is ineligible. The price of success is withdrawal of benefits.

In the field of education and training alone, program proliferation has been daunting, even to the specialist. In lower education, for example, headstart and Upward Bound appeared, as did Title I and Title II and Title VII and Title IX. On their heels followed PL 94-142. Each was a program designed to remedy a specific problem or set of problems.

Higher education witnessed the same proliferation of programs--Pell Grants, GSL's, College Work-Study, NDEA. Not to be outdone, "education" programs appeared in non-education agencies: social security benefits were extended to orphans and the children of disabled workers until their twenty-second birthday so long as they were full-time students. Indeed, until their untimely demise in 1981, social security benefits for students were the biggest single source of aid to higher education on the government books. Similarly, the Department of Agriculture has become a major player in education, providing funds for free and reduced private lunches and breakfasts for millions of children.

It is clear that this extensive and pervasive program strategy had a good deal to do with the education system; what it had to do with "education" is less clear. From an education standpoint, such programs were virtually content free. Program effectiveness was measured not on the basis of whether or not children learned, but whether or not "program services" were delivered as intended. Indeed, this was the principal task--and finding--of the largest single education study ever conducted at Congressional direction: the Title I study conducted by the National Institute of Education in the early 1970s, at the direction of Congress, looked not at education outcomes but the extent to which the program met Congressional mandates for reach and coverage.

Not surprisingly, the education "outcome" evidence for Title I (now Chapter 1) and programs like it is weak to nonexistent. How could it be otherwise given the incentives and disincentives designed into such programs? The program outcomes are precisely what one would expect. Services are provided poverty stricken children (and the schools they attend) in every Congressional District in the nation. Equally unsurprising, most recipients tend to like the program, as who would not? The price of the gift is simply to spend it. That it is spent largely in the form of salaries for school employees to deliver services to children who would be in class in any case makes it all the more appealing to the recipients. Not surprisingly, such programs are as much middle class as lower class welfare. The money goes to a "service provider," the service is given to the hapless recipient. In outline, it look much like the settlement house approach of the late nineteenth century. The primary beneficiary is almost always a middle class "caregiver" a teacher, social worker, or other professional. Only in the case of direct income or service transfer-social security or food stamps for example, is the initial recipient also the prime beneficiary.

In this regard, Title I of the Elementary and Secondary Education Act is the quintessential post New Deal federal program, because it pays middle class professional (and a few working class para-professionals) to "take care of" poor people. Superficially, it also meets the ancient Asclepian test: "Do no harm." Historically, that such programs may do little good was only infrequently an issue. (Without being unduly cynical, it is worth noting that if such programs worked very well, they would be the cause of their own undoing. The professionals who make their living from them have a strong incentive to see that they work only "well enough." Well enough to escape the budget cutters' attention, not so well that they brilliantly succeed. Either extreme dooms the program.)

As one would expect, such programs help most those who are most likely to help themselves. Asian immigrant children, for example, do very well in the nation's public schools, even poor inner city schools. Supported by family, tradition and culture, Asian youngsters do well while American youngsters from deprived backgrounds--black, white and Hispanic--are still left behind. The issue is an old and familiar one in public policy. Pernicious public policy can efficiently erect barriers to entry and performance--witness Jim Crow laws. Enlightened public policy can with equal efficiency remove barriers and obstacles to access--witness the end of Jim Crow or the emergence of major education programs to encourage poor youngsters to attend college and university. But public policy is a blunt instrument when it attempts to fundamentally alter social attitudes and corresponding changes in behavior. For better or worse, culture, tradition, history, family, and church play that role as public policy cannot. At one level of analysis this finding is most welcome--it puts to rest extravagance fears and claims about social engineering and behavior modification. At the same time, however, it means that conventional approaches to attacking social problems are not likely to bear fruit.

It is precisely the bottom end of the American workforce that is most worrisome and problematic. Indeed, there is little reason to be seriously concerned about the quality of the top end of the scale. In terms of creativity, intellectual discipline and performance, the best of the workforce has no equal. But it is not morally permissible to abandon the less fortunate. On pragmatic grounds alone a society characterized by a wide gulf between a skilled and prosperous leadership class and a dispirited and demoralized lower class invites discord and strife. Such social arrangements serve no one's purpose, least of all those who would be successful.

If the old program strategy of the past two decades offers little reason to be enthusiastic about improving the quality of the workforce, what does? What can be done to strengthen the visible and invisible curriculums? How can we reconfigure the education enterprise to more effectively serve its students?

There are two answers, one at the state level, one at the federal. At the state level, habits of thinking about education must change radically. States--constitutionally responsible for education--are the central actors in the reform process now underway (see Denis P. Doyle, Terry W. Hartle, Excellence in Education: The States Take Charge, American Enterprise Institute, 1985).

The single most important change in state attitudes toward education must be a shift from thinking about schools in terms of "input" to thinking about "output." For decades state, federal, and local policy makers evaluated what schools did--and what policy makers did for schools--in terms of "input:" how many hours were there in the school day and week, how many days in the school year, how many books in the library, how many students per teacher, how many dollars per student and so on ad nauseum. The reasons for such an approach are deeply embedded in history and tradition; suffice it to say they are no longer appropriate.

Today the question must be, "what is the value added by school?" What and how much do students learn, and what settings are better than others? Most teachers and administrators react to "output measure" proposals with indignation: publicly they assert that such a vulgar approach will damage the tender psyches of their charges. And moreover, schools do more than teach facts; they have an affective domain.

Indeed they do, one might respond. And if they don't teach the facts the lesson learned in the affective domain is that ignorance is bliss. In any case, the lesson of the early 80's is already clear. Education is locked in a fierce struggle with other domestic program for scarce resources and its constituency is diminishing. Its credibility has already diminished significantly. Education, then, must be able to demonstrate--to the public and policy makers alike--that its claim on the public purse is legitimate. To do so it must show that education makes a difference, that it is better to be well educated than poorly educated, that some schools invest their resources more wisely than others, and that success in the public sector should be rewarded and failure punished, just as it is in life.

The implications of output measurement at the state and local level are truly revolutionary. If state academic standards are specified and met, a local school can be left to its own devices as it organizes its intellectual and social life to meet those objectives. If they are not met, the responsible school can be put into receivership, declared to be intellectually and academically bankrupt.

By the device of meaningful performance measurement the state escapes the oldest of bureaucratic conundrums; in bureaucracies everyone is held to the same low standard. Mediocrity reigns supreme. The idea of performance measures is one well developed in business. The CEO cares not a whit how a division meets its objectives so long as it does. Performance measures, then, professionalize organizations, because they restore the role of judgment and decision making. In this case it is useful to remember the purpose of bureaucracy: to institutionalize the suspension of judgment. Bureaucracy is hostile to good education.

If the state role is to set high standards and see that they are met, what is the federal role? It is modest. There is little of a direct nature the federal government can or should do in the world of education standards.

Washington neither operates nor controls schools, nor should it. Washington can, however, play a decisive role in one arena: it can report the facts and let them speak for themselves. It can set the stage for old fashioned, invidious comparisons between and within states. It can collect the data and subject it to rational analysis in such a way that the hand of the local and state policy makers will be strengthened.

This is hardly a novel idea, but it bears repeating: educators do not like to be compared for good reason. They have much to be fearful about. With comparison their shortcomings will be revealed. If Washington has any role at all, it is to permit much needed comparison and contrast.

Effective firms, effective governments, effective modern organizations in general are finally aware of an iron law of successful management: responsibility for problem solving should be as close to the problem as possible. Each organizational level should so what it does best.

In conclusion, strategies to improve the workforce are necessarily general and must be painted with a broad brush: specifics--tactics, if you will--flow from strategy. Two simple truths are clear; American students do not work hard enough because too little is expected of them. Neither do they master the substance of a good liberal education. As a consequence, they do not acquire those attributes necessary to become productive workers. There are, of course, exceptions to any generalization, but on balance the evidence is incontrovertible. But if standards are low and performance mediocre, it can be turned around. Performance standards and accountability at the state and local level can make a difference.

As it happens, the nation's employers are willing to pitch in--not as philanthropists or altruists--but as parties at interest. Business needs a workforce that can do the job. It recognizes the importance of education. It is willing to pay more for good education subject to one condition: there will be more dollars for education when there is more education for the dollar.

The ball, then, is in public education's court. Public education can rise to the occasion and meet its responsibilities to its students; it can raise standards and see that they are met. To do so will restore public confidence. To fail to do so will forfeit it.

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Mr. **Nordlinger**. Thank you, Denis.

Our next speaker is Katharine Lyall, acting president of the University of Wisconsin system. She was formerly staff economist with the Chase Manhattan Bank, professor of economics at the Johns Hopkins University, and Deputy Assistant Secretary of HUD in the Carter administration.

Ms. Lyall.

PRESENTATION OF KATHARINE LYALL

Ms. **Lyall**. Thank you. I'm pleased to be here, not for the reasons you might suspect, but because it was –10° when I left Wisconsin this morning, and it's virtually spring here or perhaps well into summer by that standard. [Laughter.]

But I'm also pleased to be here because it gives me a chance to say a few things about the relationship between higher education, or perhaps I should say "postsecondary education," and the general topic of creating a world class workforce.

Denis has just talked about some of the problems in the elementary-secondary schooling areas. There are some of those same problems in higher education, but we have our own unique set of challenges that are in many ways different from those in elementary-secondary education, as well.

I think you may recall J.M. Clarke, who was one of our indigenous American economists, said "Knowledge is the only instrument of production not subject to diminishing returns." I think, however, when we think about that matter of knowledge as a means of production, it's clear, increasingly, these days that American colleges and universities are being looked to for assistance in building and rehabilitating economic resources in the Nation.

There is, at least for public institutions, the sense that we have invested in our universities, and it is now time for them to pay off in direct economic ways. The major land-grant and research universities across the country contribute by undertaking more than half the basic research done in the United States and a significant share of the applied research, as well.

Increasingly, in recent years, we have established centers and institutes to work directly with business and industry on particular kinds of problems, to help develop and test new products for the market, to provide management and technical assistance to businesses large and small, and to encourage entrepreneurship and technology transfer from the university laboratory to the commercial marketplace.

Each of us also assists our own State governments in their increasing attempts to attract new and relocating businesses to expand local tax base.

My own university, the University of Wisconsin system, alone contains 4 product and entrepreneurship centers scattered around the State, 22 industry-specific consortia seeing high technology and traditional industries inside and outside the State borders, a vigorous and growing biotechnology center, a statewide network of small business development centers, eight schools and departments of business, three engineering schools, and in order to keep this all straight, two clearinghouses, one at the University of Wisconsin-

Madison and two at the University of Wisconsin-Milwaukee, to help potential users find their way through this maze of resources to the faculty expertise they may need through the system.

I tell you this not because I think the UW system is unique, but because I think it is more typical than not of large research organizations in higher education these days trying mightily to respond to the economic development needs and requests of business and industry.

There are some things that universities, though, do not do very well, and one of those is responding to short-term consulting or crisis conditions in business. Another of those is providing venture capital for small businesses or starting businesses. And I say that, notwithstanding the several successful efforts at university research parks around the country. I think those are the exception rather than the rule.

And we are not very good at doing proprietary classified research in the university setting, much of which is of interest to business and industry. But I worry sometimes that our increasing focus on service to business and industry in these direct ways, under the banner of economic development and transition in the American economy, may cause us to short or slight our primary mission, which is still that of training and teaching students who will become members of the productive workforce and productive citizens as well.

Increasingly, good teaching and good learning is learning how to learn and learn and learn again. So that the demands on higher education's resources to assist in the economic development and transmission of the American economy are increasingly competing for our scarcest resource, which is our faculty expertise and scarce faculty talent. We are finding ourselves having to make some very tough policy choices. We have to balance our teaching responsibilities against our research responsibilities, our responsibilities for basic research against those for applied research and consulting and our responsibilities to assist in very direct ways in State or local economic development efforts against the traditional mandate to cooperate in international exchange of ideas and open exchange of intellectual property, if I can put it that way.

Let me tell you just a bit about how the demand for our services in higher education has changed, I think as a result of the economic challenges and the transition forces that we've been talking about for the last day and a half. The demand for higher education services in the United States is the product right now of two major trends, one of those, the economic shifts of the last 6 or 8 years that we talked about in some detail, but also the result of a commitment that has marked off higher education in this country from that in Europe and, indeed, in Japan and other Asian countries, as well, and that is an approach to open educational opportunities and open access to higher education, as opposed to an elitist approach to higher education.

To give you a sense of what that means, before World War II, approximately one in five Americans were students in higher education or would go on to college or university, and most of those were white males. Today something slightly in excess of 50 percent of those who graduate from high school will go on to higher education in some form, and the major increases in that total have come among those segments of the population that were least represented immediately following World War II. So that women have increased from about 20 percent to about 52 percent nationally of those students enrolled in higher education, and interestingly also, the number of adults, that is, those 25 years of age and older in higher education, has increased dramatically from less than 5 percent of the population right after World War II to something slightly in excess of 30 percent of the population now.

In fact in some of our institutions in Wisconsin, we have between 40 and 45 percent of our students who are over the age of 25, most of those people returning for second degrees or retraining or mid-career changes of one kind or another.

So the United States higher education and postsecondary training system differs from our competitors in the world market, philosophically, by being focused on broader opportunities than has been typical of our competitors, and it is also different, I think, by a commitment, at least in our land-grant institutions and our public institutions, to a rather pragmatic curriculum. Rather than adhering exclusively to the classical curriculum in higher education, we have increasingly moved to include computer science, agricultural courses, technology and many other programs in the college curriculum which do not appear in some of our competitors' curriculums.

People understand the value of education these days, and they are demanding more access, not less, and more quality, just as Denis indicated, in elementary-secondary education circles.

If I think about what the world workforce will look like in the next decade or two, it seems to me that they will clearly be more participatory in the workplace in setting and pursuing the overall goals of the enterprise. I think they will be more adaptable and versatile to job changes and job requirements. I think they will be more internationally aware, I mean aware of international trends that affect their companies, their corporations, their services, and their products in international markets.

And they will be drawn increasingly from minority backgrounds, more so than at any time in this country. And for those students, we must do a much better job of quality education.

In short, in response to the general topic of this panel, "Creating a World-Class Workforce," I think we have a world-class labor force in this country, but it has been obscured for the last few years by the overvalued dollar and by the trade deficits that we've talked about. The longer-term danger is that we conclude that we can no longer afford that kind of educational excellence, and thereby, undercut the kind of human capital investment that we have made over many, many years.

Flip Wilson, one of the great economic philosophers of our time, I think identified the essence of investment quite nicely. He said "You can't expect to hit the jackpot, if you don't put a few nickels in the machine."

[Laughter.]

And I think we have put a few nickels in the machine, and we have hit the jackpot. I hope we will continue that commitment.

[The complete presentation of Ms. Lyall follows:]

Testimony of Dr. Katharine Lyall
Acting President, University of Wisconsin System
at the
Joint Economic Committee of the Congress Symposium on
The American Economy in Transition

It is a great pleasure to be invited to participate in this Symposium and to see many of my old and familiar colleagues as participants as well. This session titled "Creating a World-Class Workforce" provides an opportunity for me to share some thoughts on the place and function of colleges and universities in the economic development and transition of the American economy. The previous panels have dealt with the macroeconomics of growth and price stability, with levels of debt and the productivity of the American compared to other world economies with which we must increasingly compete, and with the economics of families and the prognosis for their economic prosperity or decline in the coming decades.

John Maurice Clark, one of the original, indigenous, and thoroughly American economists once observed that "Knowledge is the only instrument of production that is not subject to diminishing returns."

Marc S. Tucker, Director of the Carnegie Forum on Education and the Economy put it somewhat differently: "Education has been defined as a consumption good, not as an investment we make in productive capacity. The truth, however, is that the only long-run solution to our economic problems is to increase the quality of our goods and services and the productivity of the people and organizations that product them. Education may be the most important single investment we can make on both counts."

Flip Wilson, captured the essence of investment when he said: "You can't expect to hit the jackpot if you don't put a few nickels in the machine."

However we phrase it, American colleges and universities are being looked to increasingly for assistance in building and rebuilding the economic resources of the nation. There is, at least for public institutions, the sense that we have invested in our universities and it is now time for them to pay off in direct economic ways. The major land-grant and research universities across the country contribute by undertaking more than half the basic research done in the U.S. and a significant share of the applied research as well. Increasingly, in recent years we have founded centers and institutes to work directly with business and industry on particular kinds of problems, to help develop and test new products for the market, to provide management and technical assistance to businesses, large and small, and to encourage entrepreneurship and technology transfer from the university laboratory to the commercial marketplace. Each of us also assists our own state governments in their increasing attempts to attract new and relocating businesses to expand the local tax base.

The University of Wisconsin System alone contains four product evaluation and entrepreneurship centers scattered around the state, 22 industry-specific consortia serving high-tech and traditional industries inside and outside the state, a vigorous and growing BioTechnology Center, a statewide network of small business development centers, eight schools and departments of business, three engineering schools, and two clearinghouses, the University Industry-Research program at UW-Madison and the Office of Industrial and Technology Transfer at UW-Milwaukee, to help potential users find their way to this panoply of resources and faculty expertise throughout the University System.

In short, where business and industry once searched for sites that provided proximity to minerals and water needed for the manufacturing process, the availability of railheads and other shipping facilities, and a pool of cheap labor, the process of site selection today has become vastly more sophisticated and the requirements more attuned to university-based scientific and engineering activity. Universities in both their on-campus research and their extension efforts have become a critical part of the state's resources for economic growth and change. Higher education is an important catalyst for change in methods of production, in organizations, and in individuals.

But it is also important to note that these activities, directed to closer working relations with business and industry, also compete vigorously for the university's scarcest resource: the time of our faculty. In assessing what universities can effectively contribute to the change and development of the American economy, it is well that we be realistic about both our strengths and our weaknesses. There are some things the university can do well in this arena and some that we cannot do as well as others. Among the things the university is equipped to do well are: basic research and related long-term product development and assessment, specialized problem-solving relating to basic research questions, and the provision of linkages to national and international expertise in many special fields through the personal working contacts of our faculty with colleagues throughout the world and through our specialized data course, libraries and journals designed to disseminate scientific developments and information.

However, we must never lose sight of the fact that the university's primary mission is to educate students. Increasingly, this requires not only specialized technical education but broader general education as well to enable individuals to adapt to changing fields and exploding knowledge in their fields. It has been estimated that nearly half of the students who graduate from college this year will take jobs that will no longer exist, substantially in the same form, as little as five years later. Economic transition requires flexible and adaptable individuals who can meet these rapidly changing demands intelligently. These days, the essence of education is to learn how to learn . . . and learn, and learn again.

In thinking about the future of the American economy and the importance of higher education to that future, I am worried by the frequent expressions from many segments of society that America can no longer afford to invest in our future workforce, that we can no longer afford to provide the opportunity for broad access to higher education and that it is more important to cut taxes than to support investments in education, health care, nutrition, and others that go to the heart of our economic base: our people. As economists, we know that what counts is the benefit/cost ratio—to look at these investments in human capital solely as costs is a mistake that would rob us of our future.

January 17, 1986

Mr. **Nordlinger**. Thank you very much.

Our next speaker is W. Norton Grubb, associate professor of public policy at the University of Texas.

PRESENTATION OF W. NORTON GRUBB

Mr. **Grubb**. Thank you very much.

Chairman Obey, Members of Congress. I thank you for the opportunity of giving what I understand to be the penultimate discussion of this conference, though I gather I will not have the last word; that will be yours, Chairman Obey.

I'd like to speak about the role of formal schooling, particularly secondary and community college education, in creating a world-class work force. But I think at the outset a caution is in order. A number of reports over the last 2 or 3 years have argued that if we simply improve the quality of education and increase the amount of science and math education in the schools, we will thereby improve productivity, economic growth and international competitiveness.

This is a kind of supply-side policy applied to the education system, assuming that if we supply more skilled workers, then demand for their skills will, in fact, materialize.

Well, supply-side policy has been in disrepute over the last couple of years, and I think it quite appropriate to be as cynical about that kind of policy in the education world as in the rest of economic policy. It clearly isn't true that simply upgrading the quality of the labor force will increase our international competitiveness. Many of the factors affecting our international position are outside the power of the schools to change, including international exchange rates, relative wage levels, investments in new technology, entrepreneurial ability and entrepreneurial mistakes.

So I think a well-educated labor force is a prerequisite to economic development. It's necessary, but not sufficient, and we shouldn't overestimate the power of education.

The first question to raise is whether the education system is producing the kinds of workers that will be necessary for future international developments, and whether there will be shortages of skilled workers or technical workers.

We've heard a great deal over the past decade about the rapid growth of the technical labor force and the growth of computer-related occupations. The most recent Bureau of Labor Statistics confirm these patterns. The fastest growth rates between now and 1995 will come among paralegals, computer programmers, computer systems analysts, medical assistants, computer repair personnel, followed by electrical engineers and technicians, computer and peripheral equipment operators, all of those being fairly well educated positions, and most of them in the high technology area, as well.

But although these occupations have high rates of growth, the number of people involved will be relatively small, so that all these occupations I just mentioned will account for about 7 percent of new jobs over the next decade, no more than that.

The largest numbers of new jobs will come in the following five occupations: cashiers, registered nurses, janitors, truck drivers, waiters and waitresses, all positions requiring very little skill, if any, and all positions which have really nothing at all to do with our international position. These five positions will account for about 15 percent of new jobs, as compared to fewer than 4 percent in the five occupations with the highest growth rates.

So we shouldn't mistake or exaggerate the direction of the labor force. There is a drift toward more high technology positions, toward more managerial, professional and technical occupations, away from farmers, away from operatives and away from unskilled workers, but the shift is rather small and quite slow. There's every reason to think that the schooling system can keep up with a rate of change that is as small as it is.

There's verification from this, again from the Bureau of Labor Statistics, which has projected the occupations in which there are likely to be serious shortages over the next 10 years. Those occupations with shortages include specialized veterinarians, several kinds of medical technicians, part-time and temporary secretaries, coin machine repairers, and Roman Catholic priests. These jobs may be necessary for our physical health and for our spiritual health, if you will, but they don't have very much to do with our international competitiveness.

In my view, the opposite danger exists: there may be such an infatuation with high technology that we will have an oversupply of workers trained for technical positions. The likely effect of that would be to generate more overeducation. Overeducation has been a problem in the labor force, at least in the post-World War II period, meaning that students take jobs for which they are overqualified.

We do have a couple of mechanisms to avert this danger. One is better labor market information to educators and students, more guidance and counseling to bridge what I like to think of as the two worlds of schools and firms.

A second kind of policy would include direct efforts to increase the demand for educated labor. If you are upset, as I am, about the fact that cashiers and janitors are among the most rapidly growing occupations, then more direct efforts are necessary to upgrade the U.S. labor force. My presumption is the only real way to do this is to have policies that operate simultaneously on demand and supply, rather than leaving it only to the schools and to an educational supply-side policy to upgrade the labor force.

If the educational system is doing a fairly good job of providing the kinds and quantities of workers necessary, what about the quality of the workforce? Here the complaints have been remarkably consistent, from businessmen, educators, labor leaders, and many concerned about the drift of the labor force.

The first concern is the workers must be able to change. They have to be able to adapt rapidly to changing positions, rather than being so specialized that they must be completely retrained every time there's a change in economic conditions.

What this in turn means is that education needs to be relatively general and flexible rather than specific and narrowly defined training for particular firms. The view that training ought to be rather general and flexible is an old one. John Dewey worried about it at the turn of the century, as have many other educators. But there have been serious pressures within the educational system to specialize: within the high school with the increase of vocational education; within vocational education with increasingly specific kinds of vocational education; within the community college within the drift toward vocational specialties since about 1960; and within the 4-year colleges with what's sometimes referred to as the "new vocationalism" among students majoring rather narrowly in business specialties, engineering, library science, and other sorts of professional programs.

The trend toward specialization continues in a couple of other forms. One is customized training, where schools provide training for particular firms, and second, in the public-private partnerships, which have been one of the fads of the 1980's, where public institutions provide specific training for individual firms.

If we conclude that we need flexibile and general education rather than specific and narrowly vocational education, then it becomes crucial to resist the pressures toward specialization at every level of the education system, and to ensure that these public-private partnerships are not just public support for private training.

Another concern about the quality of the labor force has been variously described, but many commentators have mentioned that we need more higher order skills, or ability to learn or learning to learn skills, or the ability to think critically, or problemsolving skills. Of course, the classical liberal education, in some sense, was designed to foster these sorts of higher order skills, and many people who lament the decline of critical thinking have also criticized the schools for the decline of academic standards.

But although there's been a great deal of unanimity about the need for critical thinking and higher order skills, and although many States have worked to increase academic standards over the next couple of years, I think we ought to admit that no one is really quite sure how to teach critical thinking. It's not clear that simply increasing requirements for math and science, or teaching history and literature in the same old ways with memorization of dates and memorization of the plots of Shakespeare plays, is really the way to foster critical thinking. I think there's a great deal to be done to develop curricula and methods that foster critical thinking, and the Federal Government is in an excellent position relative to the States to support this kind of educational research and development.

A third aspect of labor force quality is similar to what Katharine Lyall mentioned, and that has to do with the variation in abilities within the labor force. To my mind, a world-class labor force is not one with a few highly trained workers and then a mass of unskilled laborers. There's been a lot of concern recently about rates of functional illiteracy in the labor force; that concern has come most bitterly from the business community, which often finds itself with relatively incompetent workers.

Community colleges have been forced to spend a great deal of their resources on remedial programs, as have 4-year institutions, as have private firms. And so it's clear that if we're to have a well-trained labor force, a labor force that is well-trained throughout its different layers, we need to improve capacities at the bottom of the labor force. Illiterates are basically unemployable, no matter how healthy our economy is otherwise.

In the past 2 or 3 years, it's been quite common to claim that we must have equity and excellence both. The National Commission on Excellence in Education said it quite well:

> The twin goals of equity and high quality schooling have profound and practical meaning for our economy and our society, and we cannot permit one to yield to the other either in principle or in practice.

But in fact, proposals for combining the two have been quite rare, and the State reforms which have taken place over the past couple of years have tended to emphasize academic standards without any parallel measures to ensure that all students, including poor students and minority students, can meet these standards.

At the same time, we all know that the Federal commitment to compensatory education, to bilingual education, to special education for handicapped kids, and to scholarships for low-income students has been reduced. Ironically, waning commitment to these forms of education has come just as we are beginning to understand which of these programs really work for poor kids and for minority kids, and just as we've had some notable successes in providing equal opportunity, in particular narrowing quite dramatically the educational differentiations between blacks and whites over the last 10 or 15 years.

I conclude, therefore, that if we're to have a high-class workforce, it is necessary to reaffirm this commitment to equity and to develop methods of joining equity and excellence, rather than simply engaging in rhetoric about the two. This is going to mean, in my view, beefing up some of these compensatory programs, eliminating the tracking that now takes place in schools, and probably weakening the vocational education system, which contributes to tracking.

My final point is really about the unhappy subject that I'm sure you've heard a great deal about over the last 2 days, and that is funding. It's been popular over the last couple of years to propose rather grandiose schemes for reforming education without mentioning how they are to be funded. And I have done that too. I've mentioned a number of initiatives I think are important: more labor market information, better guidance and counseling, direct efforts to increase the demand for educated labor, the development of curricula and methods to teach critical thinking, compensatory education, and other Federal reforms.

And they all cost money. Well, you know better than I that this is the era of Gramm-Rudman. And education programs are not protected by Gramm-Rudman. Therefore, they are likely to suffer automatic cuts. States will be in the unfortunate position of having to compensate for other kinds of cuts, particularly cuts in the urban-related programs, and it's hard to imagine that the States will put more money into educational programs.

So I conclude that there's no way to do much about developing a world-class labor force without getting out of the bind of Gramm-Rudman, and that means, of course, increasing taxes. If that's an unpopular position to take, then we should always remember that our international competitors, as Denny Doyle has suggested, tend to tax themselves at much higher rates than we do.

There are other changes we could make in education financing. I think, in particular, we ought to work toward a sort of Federal-

State partnership, as distinct from the situation we now have where the Federal Government funds educational activities that States don't fund.

We have to face squarely the issue of funding the kinds of educational changes that we need. If we don't face that issue, then we have to admit that we don't want to develop a world-class labor force.

Thank you.

Mr. NORDLINGER. Thank you.

Well, we must be getting close to the next session of Congress because a lot of the questions have to do with that very subject of where the money is going to come from, where the nickels are coming from to pay for this development of a world-class labor force.

Before we get into the questions, I have one question of my own. It seems to me there was a premise in the topic that, in fact, we do not have a world-class labor force at the present time, but Dr. Lyall suggested that maybe, in fact, we do, but it's being obscured by the high dollar.

So I'd like other panelists to address that. Is there a question in your mind? Do we or do we not have a world-class labor force at the present time?

Mr. CHOATE. It's my perception that we do, indeed, have a world-class labor force. The issue, though, is will we continue to have a world-class labor force over the future? There is mounting evidence, I think, that if we continue the present course, we will not have a world-class labor force. We are not doing the things that are necessary to assure that our workers receive the training, that they make the adaptations that they must. And that, it seems to me, must be the central issue, is how do we continue to have a flexible, well-educated, adaptive, productive workforce?

Mr. DOYLE. Yes; I would agree generally with Pat that we do, and the question is, what's going to happen in the future. Pat uses a figure which I have to the effect that the workforce of the future will draw disproportionately on women and minorities, and that is, or course, where the problem lies most dramatically in our inner cities. In particular, young Hispanics and blacks are not getting the kind of education they need to participate either for personal satisfaction or for long-term social gain in the workforce. It is critically important to remedy that problem. We've got to.

Mr. NORDLINGER. Well, that gets to the thrust of a lot of the questions.

The first one: Who pays for building a world-class workforce, the private sector or Government? With respect to the contribution from Government during this difficult era of budget deficits, how can we finance what needs to be done? Finally, what kind of investment is needed to help the hardcore unemployed with very few skills, so they too can become part of the world-class workforce?

Would you like to address that, Pat?

Mr. CHOATE. Well, I'll take the first cut at it.

It seems to me that perhaps the most appropriate way to approach the question of financing is to break the challenge into parts and then take the parts and sort the responsibilities of who will be responsible for what.

One of the parts, at least in the post-secondary, and I'll leave the kindergarten through 12 to Denis and others who can speak to that very well indeed, but on the vocational-technical type of training, I think we must recognize at present that the State and local governments put up over 90 percent of that money. The Federal Government, through the Vocational Education Act and some smaller programs, wind up putting up that balance.

It seems to me that the challenge we have here, even if those funds are cut in half, is to take the national interest, those moneys, to modernize those facilities. I think that's the real question. How do we make sure that those State and local governments are able to offer state-of-the-art training with first-class equipment and faculty skills that are kept up to date. So that's one challenge.

It would seem to me that the primary responsibility for educating and retraining the preponderance of Americans that will constitute our workforce, that is, those that are already employed, is a responsibility that disproportionately must fall to employers. But as Chairman Obey mentioned earlier, what we have today of the three factors of production is a situation in which public policy gives disproportionately much greater incentives for firms to invest in capital and technology then it does in improving workforce performance in people. In other words, our public policy is biased to machinery instead of people. In fiscal year 1986, it will be in tax incentives, at least 3,200 to 1.

It seems to me that we must find the ways and means, in effect, to equalize those incentives and encourage employers to invest more or remove many of the incentives for investment in machinery.

Then, finally, on to the question of the displaced worker challenge, I have written, as have others, on the need to create a new form of a program, a new comprehensive, national, displaced worker program called the Individual Training Act. It's been introduced into the Congress and the House by Congressmen Durbin and Boehlert and in the Senate by Senators Hart and Simon. This bill would, in effect, share the responsibility between employers, workers, and the Government by attempting to marry concepts of the GI bill and the individual retirement account in which workers and employers would build up a training account that would be available for their use, with great latitude, at the point that they're displaced. And of course, if they do not need the funds, when the worker retires, the worker will receive those funds back, plus accumulated interest, exactly as though it were an IRA, and the employer would receive their funds back.

So my thoughts are that the present situation and the tight budget, I think, can help us concentrate on the fact that that in itself, while it will cause difficulties, is not and should not be a barrier for not undertaking many of the actions that we require, because innovative approaches are possible to finance the training that we need now.

Mr. DOYLE. The answer is, of course, we pay. We pay out of two pockets. One as taxpayers, one as private citizens, and some balance has to be established between the two. Clearly, we have to dip more deeply into our taxpayer pocket and taxes have to be raised. But I see no realistic possibility of that occurring at the national level. In deference and all due respect to the Members of Congress here today, I view the Congress as being in intellectual and political gridlock. I see no possibility of increased domestic spending for programs like education to the end of the century.

I think the burden falls, of necessity, if not by desire, on the States. I think the States have demonstrated a willingness, even an eagerness, to enter the breach. Over the past 4 or 5 years, States as unlikely as Mississippi have reached deeply into their pockets, so too has North Carolina, South Carolina, Florida, Minnesota, California. The list goes on and on. Very significant changes in States attitudes and State policies, very welcome changes have occurred. And like it or not, the burden is at the State level for elementary and secondary education.

At the level of higher education, I think we're going to have to dip more deeply into our pockets as private individuals and pay as we go. We have to reassert family responsibility. We have to means test guaranteed student loans. We have to expect, in higher education at least, the beneficiaries of higher education to pay more of the freight. I think that's a realistic appraisal.

Let me also say that I do think, as Katharine does, that we have the finest higher education system in the world, the best, none are even close to it. But I do think it is at some substantial risk in the near-term future, given changes in funding, the inability of this administration to propose a meaningful program of higher education reauthorization and the inability of the interest groups to get their heads out of the trough long enough to take a serious look at how we might restructure student financial aid.

Mr. NORDLINGER. There is a question raised about whether the Federal Government can play a larger role in reforming secondary and elementary education, even though they may not be able to play a larger role in financing it.

You raised a question about that, Denis, whether you thought the Federal Government may not be able to pay a larger role.

Mr. DOYLE. It can play a marginal role, as it always has. It never has played a very big role. We're talking about $6 billion or $7 billion a year, 6.5 percent of the total budget. That percentage has fallen, not because Federal funds have fallen, but because State funds have increased so dramatically. The most important role the Feds can play is to set the stage for what I like to think of as good, old-fashioned, invidious comparisons. So we can know what's going on. I'd like to see Governors chortle about test scores rather than football scores, and the Federal Government can play a real role in data collection, data management, and analysis. They can also play a limited role in research and analysis of other kinds, but beyond that, I am not at all optimistic about the Federal Government having either the wit or the resources to do very much about the excellence issues that are in front of us.

Mr. GRUBB. I don't completely agree with that. I think that there is more of a role the Federal Government could play. I'm not saying at the moment it has the wit to do that, never mind the resources, but when you take a look at the difficult issues—curriculum development and developing appropriate programs for the schools in the excellence movement—it's not clear that this is something that the States ought to do, particularly because anything that one State does could be appropriated by the other State. There's an economy of scale that the Federal Government has and an ability to generate expertise that's not available to the States. I wish the Federal Government could do more in this direction.

I also note that the Federal Government is by and large the only level of Government doing very much toward the education of a troublesome group that almost all of us have mentioned, that is poor and minority students. Compensatory education and bilinqual education are, by and large, the responsibilities of the Federal Government. I don't think that's a good situation. I think we ought to try and move toward a situation where the Feds either lure the States or force the States into greater participation in these programs. But without the Federal Government, those groups will be out of luck. And I think most of us agree that their education needs to be upgraded.

Mr. NORDLINGER. How can we measure the quality of education outputs? By what specific criteria, in secondary education, Mr. Doyle?

Mr. DOYLE. Well, the answer is conceptually tangled, and I don't want to pretend that it's an easy one, but it does seem to me that our democratic trading partners, certainly Europe and Japan and Australia provide some insights. For example SAT scores and ATC scores are the product of the tyranny of the 2-hour, $20, machine-scored multiple choice test. It has to be eliminated. We have to go to content-based subject matter examinations, which rely upon written essays which demonstrate the capacity to think, to analyze, to reason. We should probably reinstitute, as they have retained in France and Great Britain and other countries, oral as well as written examinations. There are a whole range of opportunities available to us, if we put our mind to it.

We have simply got ourselves fixated on a set of tests designed by psychologists which perform a very limited and narrow function which is to tell you your likelihood of doing well in college. That is not a very good tool for determining how good the high school is. It doesn't even tell you very much about the kid, in point of fact. There is a clear need for rethinking how we measure school output. It's certainly within our reach to do it. Again, and this is an area where the Federal Government could, in fact, play a very useful role, it's not very expensive by national standards to solve problems like this. The Feds clearly have the scope and breadth, and I would hope the intellectual resources to address a question of this kind.

Mr. NORDLINGER. The same question was posed to Ms. Lyall. How can we measure the quality of education outputs, by what specific criteria, but in higher education?

Ms. LYALL. I think—although it's the same question, I think the answer is somewhat different for higher education, because the product is a bit more complex, if I can put it that way. Certainly, the kinds of standard tests and so on that one can devise for testing analytical scores and higher reasoning and so on, are there and are used. And I do think we have to be careful not to overrely, as does Denis, on those kinds of quick and dirty test measures.

I think we have to look at multiple dimensions. We need to look at the employability of our graduates, and we need to ask employers what their experience with them is. We need to ask the students and our graduates themselves what they think their education did for them or did not do for them and how it could be improved. We need to look at their work, if that's possible, in some perspective, some time perspective after graduation—the graduates of American universities continue to carry off the bulk of Nobel prizes in the world—and a variety of other very approximate measures, but there are some ways to look at some of those things.

And I think we have to take a multidimensional approach to that question and try to identify where we can make improvements rather than trying to score people or rate people in any very precise way when they come out of the university.

Representative SCHEUER. How can our society do a better job in coping with the problem of adult illiteracy and the growing problem of functional illiteracy among high school graduates, people who complete 12 years of schooling and really don't have reading, writing and counting as everyday tools of life?

Mr. DOYLE. The first part of the problem is really to get a handle on it. We don't really know what the dimensions of functional illiteracy are. There are lots of numbers floating around. Most of them are cooked, unfortunately. The latest—last good set of numbers which came from the Federal Government in the National Assessment of Educational Progress suggested that about 70 percent of black male 17-year-olds were functionally illiterate. A shocking number if it's true. The Federal Government should make a real effort to document numbers of that kind on a regular basis, so we would at least know the scope of the problem.

Representative SCHEUER. Well, assume it is true, what are the approaches that are going to work? Our school system doesn't seem to have connected with these kids. What are the alternatives? Do we give them literacy training on the job? Do we pay them as they become literate? How do we create the incentives for these kids to engage in the learning process to acquire literacy and skills?

Mr. DOYLE. Well, without being evasive, clearly, an ounce of prevention is worth a pound of cure in this matter; to catch these kids early is essential, and we can do it. We should invest heavily in early child education of children at risk. The evidence on that, I think, is conclusive and persuasive. If we catch them early and educate them properly, we can avoid the kinds of downstream problems that you describe.

How we deal with the existing adult problem is a mystery. I wish I had a good answer for you. Everybody is casting about, even the major television networks; ABC and PBS have joined in a major literacy campaign. There is a major initiative in the private sector, adult literacy problems.

I would like to think that our schools could open after hours, on weekends and summers to provide adult literacy programs on a larger scale. These have not been notably successful. It does seem to baffle most people, in terms of how you cure a problem once it's occurred. I would just stress the absolute importance of trying to do some prevention. Remediation is both expensive and ineffectual, and it's clearly a terrible problem for the individuals who suffer the burdens of it.

And the numbers, if they're to be believed—23 million functional illiterate adults—are simply shocking and unacceptable. I wish I knew the answer.

Mr. CHOATE. I think that the solution ultimately will be a partial solution. I think also it'll be one that will require many players acting on many fronts, and I'll be specific. I think that the Federal Government when they created the Jobs Training Partnership Act, did a very good thing, in the sense that they, in effect, said that a major focus of that program is going to be on attempting to train people for specific jobs and work by linking much of that training with specific employers to involve the private business community in local areas to assist, in other words, so that people will know when they take much of that training, that it will lead to a job, that there's something really out there when it's finished.

As to the question of whether or not we have enough funds for that program as a country is a different issue, but I think at this point, the country's probably structured, at least from that perspective of that program a state-of-the-art program. And when one begins to take a look at programs such as 7001 and Jobs for Delaware Graduates, what one really finds is that by working with many of the young people that are coming out, that are functionally illiterate, that it truly is possible to make a difference, that they can be motivated and that they can be trained, and they can acquire these skills. So I think we're in the right direction there.

At the same time, I think it increasingly important at the State and local governments, where you have the vocational and technical education programs, take a look at programs such as in the Carolinas, which are States in which you've had a large population that in many cases have not been able, particularly in the 1950's and 1960's and some parts of the 1970's, to have the quality of education that they would wish, particularly among the minorities and the black community. Those States have done something very innovative. What they've done with their technical and vocational schools, they offer preentry level training. They give people—adults, with dignity, in a manner that conveys it through dignity, basic skills in reading, writing, and training. It's then they're able to enter into entry-level training programs and then move on to the job. Again, it's a situation where they know that their effort leads to something.

Finally, the Conference Board has reported that a growing number of corporations in America, as a natural part of their training, are offering reading, writing, and simple arithmetic programs to their employees. I think again, what we really need to do in the country is find ways to create incentives for employers to invest in that kind of human capital development of their own employees. That's particularly important, I think, for medium- and small-sized firms, because most of the firms that are doing these types of investment today are your large firms. If we, in effect, can give incentives equivalent to what we do for capital and R&D, I think then that we'll find, hopefully, more medium and small-sized firms that will make the investment, even if that investment—and hopefully, that investment would be made through the public education and training programs.

So I think that, in effect, what we're talking about is trying to tackle the problem in many ways on many fronts, but I think it's a problem that we can take. The key to it is to keep the forefront of the national attention.

Mr. Nordlinger. Mr. Grubb.

Mr. Grubb. A couple of quick comments. One is that I'm not sure that it is appropriate to ask firms to support the general training, including the literacy, of workers, just as I don't think it's appropriate for government to fund the specific training of firms. And therefore, I'm not entirely happy with this drift of having firms provide basic literacy training.

The other sort of training that goes on in remediation comes largely through the community colleges. By some estimates, as much as a third of their efforts have gone to remediation. Now this is fine at the moment, but both of these solutions are typical of what we've done in education: rather than reforming a level of education which seems to be doing not so well at what it's supposed to be doing, we develop new institutional forms to serve the same function.

And so if the elementary schools fail to teach reading, then we shift it onto the secondary level and then shift it up to the community colleges and firms, and then, Lord knows, to the 4-year colleges.

This line of argument obviously leads right back to what Denny Doyle said, which is that we have to go back and reform the early levels of the schooling system, and that means, as far as I can figure out, replacing some of the programs that are now being weakened in early childhood education, compensatory education, and doing what we can to support these programs that can work.

Mr. Nordlinger. Another question. Denis, you addressed the situation in Japan, and this is a question concerning Japan.

Instead of considering Japan as an opponent, why not learn from its success? According to Martin Weitzman's "The Share Economy," Japan, through union contracts, has adopted employee profit-sharing programs which give employees 25 percent additional income through bonuses. This gives employees the great buying power, so that Japan has virtually no unemployment.

What do you think of that kind of idea for this country?

Mr. Doyle. Pat is more up on the Weitzman idea than I. And clearly, we should not see the Japanese as antagonists. They're people from whom we can learn, I hope. God knows they've learned from us. Fair is fair. It's time for us to learn from them. My only point about the Japanese that has much relevance is that we can, in fact, use our public institutions to achieve public purposes. The Japanese have demonstrated to a fare-thee-well that schools can be made to work. This is the point that I would restress.

Mr. Nordlinger. Here are two related questions. How do you want to get people from low- and middle-income families into engineering and business? And related to that, should we try to fulfill the middle class goal of a liberal arts education for everyone who desires it, or should we limit the student loans and grants to those who are studying economically needed subjects?

What do you think of that, Mr. Grubb? [Laughter.]

Mr. Grubb. Well, in terms of getting students from low-income families into engineering and business, we now have a school system that's heavily tracked, and the way that ends up working in all aspects of that system is to track out poor and minority kids, to track them into vocational and general programs, to track them into low ability groups out of high ability groups, to lead them consistently away from the academic tracks that lead up to college, to engineering and to business careers.

I think all that needs to be undone. It needs to be undone for a couple of reasons, not the least of which is the equity, but also an aspect of efficiency.

There is no evidence at all that the kind of ability grouping that takes place in the high schools and the elementary schools works, that is, that it really improves the education of low ability kids or improves the education of high ability kids. And I think there's every reason to try to demolish all of that tracking.

Second, the kinds of vocational tracks that take place also don't work. That is, at the high school level there's pretty good evidence that these vocational programs don't, in fact, provide any economic advantage, although they do prevent kids from going on to colleges where they could get into engineering and business occupations, as you've mentioned.

So we do know something about mechanisms to get those kinds of students into business and engineering positions.

We also know about another aspect of that problem related to women and getting women into engineering, that we know there's a lot of sexual stereotyping at very early ages in the school system. Undoing that is no less simple than getting rid of it in the rest of society, but at least we know what the problem is.

In terms of providing funding only for economically relevant occupations and not for liberal arts vocations, I think that is an absolutely dreadful idea. A great deal of the commentary over the last 2 or 3 years has stressed our failures, not necessarily in economic terms, but in political and humanitarian terms as a country. And furthermore, I'm not sure that the evidence is all that clear that graduates of liberal arts programs earn less than graduates of engineering and business programs. There's very little work that's being done on that. I don't think that answer is at all clear, and I think that if we're talking about capacities to change, flexibility, general skills, creative abilities, that we would do very badly to turn our attention away from the liberal arts.

Ms. Lyall. Mr. Nordlinger.

Mr. Nordlinger. Yes.

Ms. Lyall. Could I add a couple of things to that.

Mr. Nordlinger. Yes, Ms. Lyall.

Ms. Lyall. I couldn't agree more with my colleague on my left about liberal arts versus technical training or technical studies. The followup evidence that we have suggests that people who study or major in liberal arts subjects may start slower, but they finish faster. [Laughter.]

To go back to Mae West's quotation from a while ago. And they are more likely to have a more versatile and, I guess, it's a judgment, but more interesting kind of career patterns throughout their lives than people who are tracked early into a technical subject. In fact, one of the things that concerns me and a number of my colleagues in the universities, is that some of the technical programs that we now think of quite regularly as being undergraduate majors, engineering, computer science, business administration, were 20 or 25 years ago, graduate programs only. And the typical pattern was to get a broad general education as an undergraduate and then go on to those kinds of technical trainings.

You may recall in my remarks earlier, I noted that more than a third of students registered in higher education institutions now nationally are "adult students," that is, over the age of 25, and many of those that we're seeing, at least in Wisconsin, are there because as one of my colleagues unkindly puts it, they're tired of "bean counting." They've been accountants, and they've counted beans for 10 years, and they think they're missing something in life, something more broadly, and they come back to take, as adult students, the liberal arts courses that they missed as an undergraduate.

One comment on how to get minority students into engineering and other technical careers. If any of us had the sure-fire answer to that, we could transform higher education, society, and the future of the American labor force, I think, for the next several decades. It is extremely difficult.

All of the institutions of higher education that I know of try, through a variety of means to do that, but one of the things that we've learned is that it's necessary to do that through a variety of very detailed contacts in the precollege years, going back perhaps as far as the elementary schools, but certainly in the early years of junior high school and on through high school, through advising programs, through some programs of assured admission, if one takes certain courses in high school and satisfactorily completes them, through assurances of financial aid that would sustain one through the college program, and through a variety of other really morale and encouragement devices.

It's one on one, very difficult process, but one that continues and will make an important difference to the future of the work force, I think, for several decades to come.

Mr. NORDLINGER. Chairman Obey has a question.

Chairman OBEY. I do want to follow up to make certain that—well, I'll try—I'd like to determine whether we have a genuine difference of opinion here with some things that some of you said or whether it's just a lack of my clear understanding of what it is that some of you have been saying.

My question relates to your comments about technical education. I don't recall who was the first on the panel to question the utility of vocational education. I don't know if that comment came more with secondary vocational tracking in mind or whether it came as part of a genuine dubious feeling about the value of postsecondary vocational education?

Some of you suggested we maximize our attention to the liberal arts, and someone said reduce the resources that we were giving to—I don't remember if you said vocational or technical training. I would grant that it is essential to push liberal arts education. That has been my priority in higher education for the 17 years I've been here. But it's also been my experience, at least in the Wisconsin setting, where we have primarily moved to a postsecondary technical system. I opposed, for instance, in the legislature, the creation of the junior college system in my State, because I thought it would result in a proliferation of second-rate liberal arts institutions, which would not, because of the lack of social prestige associated with genuine work-related education, lead to very many job education opportunities for kids interested in work period.

What I'm trying to get at is whether you are objecting to that kind of vocational experience as well, because it's been my experience that there are a good many students who enter those institutions, who if they did not enter those institutions, would not enter any at all. And frankly, I recall one person, the father of a girl I used to date a long time ago, and he always impressed me, because he worked in the paper mill, and on the eight occasions he was asked to move into management, he said "Hell, no." He was happier staying in the mill, so he could go home at the end of 8 hours, paint and do whatever he wanted to in his private life, which he felt was much more important rather than allowing his worklife to dominate his own definition of self.

I'm concerned that the tone here seems to take on or leave the impression that there's a general denegration of the value of quality postsecondary technical training. I want to know if you really feel that way, and if you do, I would just say I disagree with it.

Mr. **Grubb**. Well, let me clarify my points of view, because I think I'm the person that mentioned it first.

I think at the high school level, vocational education has been studied extensively. There is remarkable unanimity among the decently designed studies, and they suggest that high school vocational education does not increase the earnings or decrease the unemployment of students who come out of it, except for girls in clerical and secretarial positions.

I don't think that that means there are no good high school vocational education programs. I think what that means is the good ones and bad ones have been lumped together, and we have an average of zero effect. But to disentangle the good ones is something we haven't really done, and my suspicion is that most of those good ones—for example, the programs near Kennedy Airport that provide training for airline mechanics—are really rather specific in the kinds of training they provide, specific to a group of occupations.

So I think that by and large, but not in every case, that high school vocational programs ought to be abolished as both ineffective, inefficient, and inequitable, because they do, in fact, track kids out of the academic programs, where they could go on to higher education.

Now at the community college level, I think it's quite different, and the evidence suggests that the results in community college are much more mixed. There are some programs that seem to work quite well and some programs that seem to work not at all, but at least it's mixed, and there are some positive programs, and there are lots of reasons for that.

Community college graduates are older. High school graduates are 17 or 18 years old, and employers don't hire 18-year-olds for responsible positions. Community college graduates are selected in a particular way, they're more responsible, and so on.

So there's good reason to think that what we really ought to do is shift the vocational training component of our system from high school to the post-secondary level.

Now I've been impressed in Texas by the Texas State Technical Institutes, which are not community colleges combining liberal arts and technical training, but are pure technical training institutions. They have some methods that make them very well tuned to labor market demand and to the kinds of skills that a broad range of employers require. That model is an excellent one.

So on post-secondary programs, I agree with you. I do think that there are problems at the post-secondary level, because a lot of programs do not match labor markets very well, and because the mechanisms by which students see what areas are in great demand and have higher earnings don't operate all that well. I think there's a lot of work to be done.

Mr. **Nordlinger**. Well, thank you very much. I think this ends this part of the program, and I guess we'll now go on and see what Congress does with this year's training and education budgets. [Laughter.]

Chairman **Obey**. Thank you very much, members of the panel, and thank you, Steve.

[Applause.]

Chairman **Obey**. I would ask your forebearance to stay put for just a couple of moments, if you'd be so kind, because I would like to make a few points in closing the symposium.

This, as you know, is the 40th anniversary of the creation of the Employment Act, and since we won't be doing this again for 10 years, I don't know if any of us will be around at that time.

But I'd like to make a few points about some things that I scratched down over the past 2 days: conclusions we might reach about our 2-day experience here.

We've tried to use this opportunity presented by the anniversary of the act to ask what has happened to the fortunes of the U.S. economy since 1946 and try to draw some lessons from that experience to help us better understand the challenge of today and tomorrow. The challenge of economic policy has always been formidable, but it is even a tougher challenge in the post-Gramm-Rudman period. And I think that the last 2 days have demonstrated a number of things. We, since 1946, have obviously learned a significant amount about how to make the economy grow. Before 1946, the economy was on a roller coaster, and for every year of expansion, we experienced a year of recession, roughly. Since 1946 that's changed considerably. We have managed almost an average of 4 years' growth after each recession.

In achieving that overall improvement, we've learned something about how to manage or how to combine macroeconomic policy, which encourages the overall growth [illegible]d output of production with microeconomic policies, such as the [illegible] bill and worker training, to make certain that all segments of [illegible]ciety shared in and helped create the general prosperity. That combination expanded opportunity. It reduced poverty. It contributed to the growth of the world economy. It managed it all with deficits that averaged only about 1 percent of GNP.

Since 1973, the economy or the growth of the economy has slowed dramatically. So far in the 1980's, we've managed only an average yearly growth of about 2.3 percent. If we keep this pace uninterrupted to the end of the decade, we would be lucky to achieve an annual growth of 3 percent, probably not quite that high. A far cry from the almost 4-percent average of the 1960's and not as well as the average of the 1970's.

The slow growth of recent years has been accompanied by a rise in poverty, a slight, at best, increase in productivity growth, and it has generated, in my view, a squeeze which has denied to the younger generation of workers in this country the opportunities experienced by their elders and left them dubious about the ability and the willingness of Government to provide them with that same opportunity, whether it be in the field of education, or in housing, or in other areas, job-related areas, for instance.

Worst still, that slow growth has been accompanied by a huge increase in the Federal debt. Although this huge expansion of fiscal stimulus has been insufficient to restore sufficient economic growth, it does represent a major threat to growth in living standards of this country in the future. The question still does remain, Where do we go from here?

Clearly, this symposium has established our No. 1 economic problem is the deficit. Over the past 2 days, we have seen reasonable consensus emerge on the importance of deficit reduction to our future economic prosperity. While there has been much disagreement on some of the specifics, there has been consensus, I believe, on two basic points with regard to Gramm-Rudman and deficit reduction.

First, Gramm-Rudman sets the wrong targets for deficits. It measures the deficit incorrectly and prescribes a schedule for deficit reduction which poses a threat to the stability of the economy.

Second, the right target is the structural deficit, and we should seek to balance the budget at full employment and accomplish the goal of deficit reduction without compromising the investments of Government which are essential to promote overall growth in the economy.

It is clear that deficit reduction will require action on both the spending and the revenue side of the budget. I do not, frankly, understand anyone who does not understand that basic fact. We cannot achieve the twin goals of deficit reduction and sustained economic growth unless we abandon the old ideology and refuse to let old political problems blind us to those new realities.

When you go to a doctor, you don't ask him for medicine that tastes good and feels good, you ask him for medicine that works. The new realities force us to recognize that some of the investments that Government makes, which are important contributions to growth, to equity, and to opportunity in the American economy, cannot be abandoned. We ought not to turn our backs on those challenges, as we tackle the problem of deficit reduction.

Investments in people and in knowledge, to take two examples, will require some new investments, but they will yield a major return in the future. I would say the $55 billion that we spent in today's dollars on the GI bill was money well spent.

Only if the White House and the Congress can achieve that kind of bipartisan consensus can we position ourselves to pay attention to the new challenges posed by the world economy. We need to devote significant attention to accelerating growth in the world economy, for that growth is the only effective way to solve many of our most pressing international problems, and we must confront the new challenge of international competition about which we've talked so much today.

In our competitive world, firms first must look out for their own interests. So long as the primary obligation of our corporate executives is to their own stockholders, and there's little doubt that is their primary objective, it is only our national, political institutions which are committed fundamentally to advancing our truly national interest.

My own view is that we must repeatedly defend out own national, economic interests every bit as much as we try to strategically defend our political and military interests.

Other countries have learned this lesson. Most industrialized nations and virtually all developing nations have spent considerable time in attention in creating effective marriages or at least engagement between public and private economics.

The elements of a new public economics for our country have been outlined in various sections of this symposium. Deficit reduction which pays attention to the need to maintain growth, macroeconomic policies which get beyond or at least bend the Phillips curve somewhat and permit us to have both high employment and low inflation, productivity policies which concentrate on improving the way we work today and improve the quality and the sense of participation of the workforce, investment policies which promote savings and new investment and which discourage excessive debt and speculation, wage systems which encourage flexibility without compromising wage growth, income maintenance programs which produce work, not welfare, at least not exclusively, not primarily, new arrangements for the world economy, which can resolve the debt problem and restore rapid growth in world demand.

To craft such a public economics requires the kind of pragmatic experimentation which was the hallmark of the Employment Act of 1946. Having met previous challenges successfully, there is every reason to assume we can meet the present ones, if we have the national, the social, and the political will to do it.

In closing, I would simply like to thank again all of the participants, thank the audience, thank the moderators, and the panelists, thank the staff, thank Senator Sarbanes, and Congressman Scheuer for their participation, and I would like to read you some names.

Senator Joseph O'Mahoney, Senator James Tunnell, Senator Abe Murdock, Senator Francis Myers, Senator Robert Taft, Senator Styles Bridges, Senator Robert La Follette, Jr., Congressman Edward Hart, Congressman Wright Patman, Congressman George Outland, Congressman Walter Huber, Congressman George Bender, Congressman Walter Judd, and Congressman Robert Rich.

That rollcall represents the names of the original members of the Joint Economic Committee, when it was created 40 years ago.

I don't know who will call our names 10 years from now or 40 years from now. I don't know what they will say about us. I do hope that they can say that this committee carried on in their tradition in trying to seek outside of the bounds of ideology, answers to the simple question: What works and what's right?

Thank you all for your attendance.

[Applause.]

Chairman OBEY. Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I think we would be remiss if we allowed the symposium to close without in particular underscoring your efforts in bringing about what I think have been a very important 2 days in the discussion of national economic policy. When the idea was first broached by the chairman and met with a strong, positive response from the members of the committee, I don't think any of us fully appreciated the extent to which the examination, which has taken place over the past 2 days, would be as pertinent and as relevant as I believe it is at this time, given the economic problems which we face and our failure, in my judgment, to come to grips with them up to this point.

I think we owe a particular word of thanks to those who have served as moderators of our panels and to those who have participated in the panels, all of them people of extraordinary ability and experience who have come from across the country to take part in this 40th anniversary of the JEC and the Employment Act.

I come away from these 2 days with two strong impressions. One is that the challenges facing us as a nation in the economic arena are very broad and very deep. In many ways we face a crisis and we need to come to grips with it. Forty years ago, at the time the Employment Act was enacted, was the sole dominant economic power in the world. That situation has changed markedly, in part because we undertook to change it.

In an effort to build a world of peace and prosperity, we reached out and, in effect, extended a hand to other nations and helped them toward a higher standard; and we now face, in part because of that far-sighted, and I think, generous act, a competitive world and we have to deal with it in a highly competitive fashion.

The other impression is of the extent to which panelists and the audience, as reflected by the questions could come to some framework of agreement as to what needs to be done. That was a consequence, I think, of the very informed and rational discourse that has taken place here for the past 2 days. It has been marked contrast to the rigidity, the inflexibility, and the strict ideology that have characterized much of the public discourse in Washington.

It defies all rational notions of cause and effect to note that our deficit problem comes in large part from tax cuts and increases in defense spending, and at the same time insist that we're not to address either of those two arenas in addressing the deficit problem.

That position represents complete breakdown of cause and effect. It is essential now for public decisionmakers to be willing to forego ideology and rigidity and inflexibility, to look at our problems in a reasoned way, to come to grips with them and to be prepared to consider a balanced approach. We must do this if we are to move the economy forward, always mindful and sensitive to the values and objectives outlined by the chairman in his opening statement yesterday—economic growth, fairness, and opportunity.

I think it's with a commitment to those very important principles that the committee will undertake its work in this important session.

Mr. Chairman, I close by thanking you again for your leadership in bringing this symposium about.

Chairman Obey. Thank you.

[Applause.]

Representative Scheuer. Mr. Chairman, I would like to add my thanks to you for your leadership, and also, in addition to all the other recognition that's been given, I would like to pay my respects to staff at every level from top to bottom for their remarkable team effort in bringing this hearing to such a successful—to such a marvelous level of success.

I agree with Senator Sarbanes. The fact that important voices in our society could be preening themselves and congratulating themselves that, in the face of a $220 billion annual budget deficit, we're enjoying the lowest personal tax rates in a half a century and the lowest corporate rates in 40 years, indicates that something is sadly awry. And I think the American public, if they would understand the situation, they would want to pull in their belts a hitch. They would agree to a fair and equitable tax enhancement program, if that was the price tag to getting our economic act together, enabling America to compete in global commerce, stopping the hemorrhaging of jobs and in producing the kind of economy that has always been preeminent in the world and which we can be proud.

I hope that this won't be just a 2-day sputter with the silence of the grave after that. I hope that we'll be making some plans to take this kind of discourse and this kind of superb intellectual fodder to the rest of the country, and I hope that we'll be doing that in the years to come.

We've had absolutely mangnificent witnesses. It was a pleasure and a privilege to sit here and absorb it, and I hope that we'll be tapping these witnesses and other witnesses and having hearings around the country, in this great country of ours and continue to fulfill the mission of all congressional committees, but certainly this committee that has no legislative jurisdiction, which is to educate the Congress and to educate the American public.

There's a crash program of public education to be done. This is an extraordinarily appropriate instrument to do it, this Joint Economic Committee.

This 2-day seminar that you arranged is proof positive of that, and I hope that you'll carry on and stay the course throughout the rest of the year.

Chairman Obey. Thank you very much. Thank you all.

[Applause.]

[Whereupon, at at 5:20 p.m., the symposium was concluded.]

APPENDIX

PUBLIC POLICY AND THE AMERICAN ECONOMY

Walter W. Heller, University of Minnesota

(Remarks at the 40th Anniversary Symposium of the Congressional Joint Economic Committee, Washington, D.C., January 16, 1986)

Mr. Chairman, Honored Guests, and Most Honored Guests Senator Jack Javits (in absentia) and Congressman Dick Bolling:

It is a humbling, not to say awesome, responsibility to speak to this assemblage of the movers and shakers of the nation's economic policy. As I thought about that term, it occurred to me that there really are three classes of economic policy makers—those who shake but don't move; those who move but don't shake; and then there are those in this audience tonight, those who both move and shake.

I've been asked to do the impossible tonight: examine 40 years of progress—and occasional retrogress—under the Employment Act of 1946 (and its Humphrey-Hawkins successor); the role of the Joint Economic Committee in this saga; the present state of our quest for greater growth, equity, and opportunity; and what direction that quest should take in the future. I was tempted to ask David Obey: "Is that all?"

As the obvious risk of repeating myself, I'll say that to try to cover all that in my alloted 45 minutes will require me to talk as fast as my late Minnesota compatriot, former head of the Joint Economic Committee, of whom it was said: "Hubert speaks at a rate of 100 words a minute, with gusts up to 200." Finally, I'll try to be mindful of Muriel Humphrey's gentle chiding when she said, "You know, Hubert, for your speech to be immortal, it really doesn't have to be eternal."

THE POSTWAR ECONOMIC LANDSCAPE

In a period when government activism, especially in economic affairs, is under attack—indeed, when President Reagan, charming, disarming, and sometimes alarming tells the country that government's impact on the economy is somewhere between baneful and baleful and that the greatest contribution he can make is to get governments clammy hands out of our pockets and government monkeys off our backs—against that background, the Joint Economic Committee's 40th Anniversary is an especially appropriate time to take stock of the role government has played and should play in the economy. I will undertake to do that tonight in my usual fair, objective, detached realistic, scientific, evenhanded, and nonpartisan way.

Let me begin with a broad-brush comparison of U.S. economic performance in the pre- and post-activist eras. Now that's not just pre-and post-World War II, because inclusion of the Great depression of the 1930's would make it a statistical cake-walk for activism. True, the fear of falling into another Great Depression was a prime mover in the passage of the 1946 Act. So one might reasonably claim that it should be included.

David Obey has made my task easier tonight by his superb overview of the postwar experience this morning. I am grateful to him for his lucid litany of the host of constructive measures that made up the web of policy activism to which so much of our postwar prosperity can be ascribed. And I won't repeat his broad-brush review of the superior postwar performance—at least till 1973—under the new regimen of activist public economics. But I do feel duty-bound, as an economist, to put a statistical point or two on that performance.

First, with respect to comparative economic stability: Excluding the Great Depression of the 1930's—for including it would make all comparisons a statistical cakewalk for economic activism—but excluding it, we find that the prewar economy spent roughly a year in recession for every year of expansion. Postwar, it has been one year in recession for every four years of expansion. Pre-1930 recessions were not only much longer but much deeper than postwar recessions, with a standard deviation relative to trend growth that was twice as great prewar as postwar. The shape of the typical prewar cycle was a deep symmetrical V, but postwar it was more of a shallow checkmark. Now, for those of you who are not yet sated with statistics on postwar stability, I refer you to a forthcoming JEC publication and to Charley Schultze's Okun Lectures at Yale, also to be published soon.

Second, as to comparative economic growth: Here, updating some of Arthur Okun's numbers, I find that the era of economic activism wins again. Compared with an average real growth rate of 2.8 percent from 1909 to 1929 (and 2.3 percent from 1929 to 1948), the postwar pace was a hefty 3.8 percent before slowing down after 1973 and lagging even more in the Eighties, as I will examine later.

Third, as to the comparative use of our GNP potential: The postwar activist economy operated far closer to its potential than the prewar economy. Measuring the "net gap" under the trend lines connecting prosperity years, one finds that the gap averaged 5 percent of GNP, prewar, even leaving out the Great Depression, but less than 1 percent postwar (from 1948 to 1979).

Now, where has that progress come from? You would not expect me to give the same answer that Richard Nixon gave an audience in Jackson, Mississippi during the 1960 campaign when he noted that the Mayor told him that they had had a doubling of population during his 12 years as mayor. Nixon went on to say: "Where has that progress come from? That progess has not come primarily from government, but it has come from activities of hundreds of thousands of individual Mississippians, given an opportunity to develop their own lives."

Contrary to Mr. Nixon's answer, I would agree with Okun that the improved performance record, especially the greater economic stability, must be credited to public policy. As he put it, "It was made in Washington." The automatic stabilizing effect of a larger public sector—both on the tax and on the spending side—undoubtedly played an important role. Coupled with it was an aggressive fiscal-monetary policy that, while not always on time and on target, assured private decision makers that recessions would be relatively short and shallow and depressions were a thing of the past.

Paralleling the improved economic performance in the postwar era of economic activism was a dramatic decline in the incidence of poverty. From an estimated 33 percent of the population in 1947, poverty fell by one-third, to 22 percent, by 1960—a decline that must be attributed primarily to economic growth plus some increases in public assistance and transfer programs.

Then came the uninterrupted growth of the 1960's coupled with the War on Poverty and other Great Society programs, which cut the remaining poverty in half.

Contrary to Mr. Reagan's assertion that "in the early Sixties we had fewer people living below the poverty line than we had in the later Sixties after the Great War on Poverty got under way," the President's 1985 Economic Report (page 264) shows us that the percent of the population in poverty dropped steadily from 22 percent in 1960 to 19 percent in 1964 to 12 percent in 1969, and then bottomed out at 11 percent in 1973. From then until 1980, growing transfer payments just managed to offset sluggish economic performance, and poverty stayed in the 11 percent to 12 percent range until it shot upward in the 1980's. More of that later.

Perhaps the most gratifying testimonial to the success of activist socio-economic policy is the striking advance in the economic status of the elderly, a cause with which Senator Javits has been so closely identified. Since the media have recently discovered and hence covered this phenomenon at length, I need only to cite one or two salient facts: 25 years ago, 35 percent of older Americans (65 and above) were in poverty. But 1984, that number had dropped to 12.4 percent, 2 points lower than the poverty rate for Americans overall.

DOWN MEMORY LANE

Now let's turn some of the pages in our postwar economic history, partly to make a few points about good and bad policy and about the reshaping of the 1946 Magna Carta as the decades passed, and partly just to reminisce a bit, as seems appropriate on an anniversary like this. In doing so, one should not forget Jackie Gleason's dictum that "the past remembers better than it lived" and the companion warning that "reason is to nostalgia as wind is to fog."

The early postwar years were really vintage years in our fiscal policy annals. We ran appropriate surpluses (that alone shows I'm dealing in ancient history) in 1947 and 1948. Then, in mid-1950, the Joint Economic Committee, in one of its finest hours, recognized the inflationary potential of the Korean War and led the charge to reverse gears, i.e. to take a tax cut that was half way through the Congressional mill and help convert it to a tax increase. As has been true so often, it was providing the intellectual leadership in Congress on economic policy. But I must add that not everyone followed.

Joe Pechman will vividly recall those early-1951 days when we sat in Executive Session in the Ways and Means Committee room (side-by-side with Colin Stam and Charles Stewart) carrying the ball for the Treasury proposal for a $10 billion tax increase to fight off the inflationary consequences of the Korean war. As we made the case for that huge tax hike, the 88-year old chairman of the Ways and Means Committee, "Muley" Doughton looked at us sternly and said, "If I thought that even one dollar of that $10 billion was for those new-fangled ideas about fighting inflation instead of sending guns and tanks and planes to our boys in Korea, I'd vote against it." As I recall, my response would have done credit to Cap Weinberger. (In passing, I might note that I've discovered the real reason why Mr. Reagan initially signed the Gramm-Rudman Bill without any ceremony. He feared that Cap might take his presidential pen and commit hara-kiri with it on the spot.) We got $7 out of $10 billion out of Congress. When Ike dismantled the Truman price-wage controls, demand had been so successfully curbed that wages and prices hardly budged. In fact, 1952-56 were years of calm on the inflation front.

But the rest of the 1950's, with three recessions in 7 years, were hardly good years of economic policy. Economic signals were missed, the Fed slammed the brakes too soon, and relaxed them too late. It was not activist policy at its best.

Let's jump to the Golden Sixties, truly a watershed, a revitalizing of the Employment Act of 1946. President Kennedy asked us to return to the letter and spirit of that Act and ended equivocation about the intent of the Act by translating its rather mushy mandate into a concrete call for meeting the goals of full employment, price stability, faster growth, and external balance—all within the constraints of preserving economic freedom of choice and promoting greater equality of opportunity. He went on to foster a rather weak-kneed anti-recession program in 1961 and a powerful growth-promoting tax cut program in 1962-64. In that process, I counted six firsts for presidential economics:

He was the first president to commit himself to a numerical full-employment target, namely 4% unemployment, and growth, namely, 4.5%.

He was the first to adopt an incomes policy in the form of wage-price guideposts developed by his Council of Economic Advisers. The guideposts, flanked by sensible supply-side tax measures to stimulate business investment, by training and retraining programs, and the like, helped maintain a remarkable record of price stability in 1961-65, namely, only 1.2 percent inflation per year.

He was the first president to shift the economic policy focus from moderating the swings of the business cycle to achieving the rising full employment potential of the economy. In that process, he moved from the goal of a balanced budget over the business cycle to a balanced budget at full employment. He was the first president to say, as he did in January 1963, that budget deficits could be a positive force to help move a slack or recession-ridden economy toward full employment.

As a capstone, he was the first president to say that a tax cut was needed, not to cope with recession (there was none) but to make full use of the economy's full employment potential.

All of that may have been old stuff to economists, but it was bold new stuff for a President. I recall that the big tax cut proposal was greeted with grave scepticism by the community at large, but the JEC helped carry the mail and the message. Most vividly, I remember the JEC Hearing early in 1963, which was distinguished, first, by Gardner Ackley's pioneering exposition, with charts and all, of the tax multiplier concept to the Committee, and second, by gaffe on the Puritan Ethic. When Martha Griffiths asked me why it was that the American people seemed so reluctant to accept this bonanza of a Kennedy tax cut, I suggested that it might be the Puritan Ethic. The next day, Johnny Byrnes, the ranking member of the Ways and Means Committee, and a worthy predecessor to Bob Dole as the ranking wit in Congress—wound up his attack on me for denigrating the Puritan Ethic with this zinger, "I'd rather be a Puritan than a Heller!"

Those were the halcyon days of economic policy. Aided and abeted by the Fed the 1964 tax cut worked like a charm. In mid-1965, just before the July escalation in Viet Nam, we saw the happy combination of an inflation rate of only 1.5 percent; unemployment coming down steadily, to 4.4 percent; defense expenditures continuing their four-year decline from 9 percent of GNP in 1960 to 7 percent of GNP in 1965; and the cash budget running $3 billion in the black.

Then came the dark years of Viet Nam in economics as well as in foreign policy. Unlike 1950-51, we did not reverse gears in spite of the timely warnings of the Joint Economic Committee and most of the economists, both inside and outside the government, who were advising LBJ.

A case in point was my trip from Minnesota to the Ranch in late '65 to plead for a tax increase. In the midst of an interlude of deer hunting on Lynda Bird's "back 2000" from the LBJ-driven white Cadillac convertible—with George Hamilton as shooter and me as spotter—LBJ turned to me—perhaps I should say turned on me—and asked: "What do you want me to do, call Congress back into special session and rescind the repeal of those temporary excise taxes?" A wise and wily man. (As some of you will recall, those temporary excise taxes had been on the books since 1933 and were universally regarded as a good riddance.) He did not propose a tax increase until early 1967, and no tax action was completed until 1968, long after the inflation horse was out of the barn.

But that was an excess-demand horse, the kind we understood, the kind that even I warned against in my rather exuberant Godkin Lectures on 1966, those lectures in which I had said "Nothing succeeds like success," but the London Economist unkindly corrected that to "nothing exceeds like success." My references to the "treasured but treacherous territory around full employment" to the fact that "prosperity without a wage-price spiral" was "a goal that has hitherto eluded not only this country but all of its industrial partners in the free world" were understandably ignored.

As I put it in testimony before the JEC in July 1970, "there are no magic formulas, no pat solutions, no easy ways to reconcile full employment and price stability. No modern, free economy has yet found the combination of policies that can deliver sustained high employment and high growth side-by-side with sustained price stability." That was all well and good, as far as it went, but in light of the experience of the 1970's it did not go nearly far enough.

The policy travails of the Seventies are too well known to require lengthy review, especially in light of Chairman Obey's deft characterization of them this morning.

First, there was the Nixon fiasco of freezes and phases serving as a facade for pumping up the economy with tax cuts, spending increases and a rapid run-up in the money supply, with sure-fire consequences of an overheated economy.

Superimposed on that were the supply shocks in 1973–74—oil prices quadrupling, food prices jumping 40 percent in two years, and other world raw material prices doubling in about the same time—that served to consolidate stagflation. The shocks, of course, were not just to the price level, but to the economies profession, led by Keynesians. We learned the sad lesson that as to wages and prices, what goes up, propelled by over-stimulated monetary-fiscal policy and a series of external shocks, does necessarily come down when the fiscal-monetary stimulus and supply shocks subside. We've learned a lot about sticky wages and prices that stay in high orbit even with visible means of fiscal-monetary support. At least, they stayed there until we administered a dose of sadomasochism, better known as the double-dip recession of the Eighties, the deepest since the Great Depression.

One should not recite the economic sins of the Seventies without acknowledging one bright fiscal episode, namely the tax rebate and tax cut enacted in the second quarter of 1975. Granted, it was a bit late to blunt the recession, but it provided a welcome boost to an economy that had fallen into what, until topped by the recession of the early Eighties, was the deepest recession since the depression. The 1975 tax cut was a winner in both size and timing.

Though prices behaved very well in 1976, when inflation averaged 4.8 percent (with the help of good crops and no increase in the real price of oil), the combination of an overly strong expansion (partly resulting from economists' over-estimates of GNP potential) and the second oil price shock soon pumped inflation back into the double digits. It was a time for economists to be mighty humble—though I suppose one should bear in mind Golda Meir's admonition: "Don't be so humble, you're not that great."

As one surveys the whole period, activist economics and New Deal instrusions into the market place can surely take credit not only for building in strong defenses against depression but for 25 years (in 1948–73) of high-octane operation of the economy and sharply reduced instability. Within that framework, one can criticize anti-recession fiscal policy as often too little and too late, monetary policy as sometimes too easy and other times overstaying tightness. And surely, the far-too-late and considerably-too-little tax increase to finance the war in Viet Nam, coupled with excessive monetary ease in 1967–68, has to go down in the annals as one of the flat failures of post war fiscal monetary policy.

Still it is worth reminding ourselves that even in the face of high performance, inflation of the 1949–72 period rose above 6 percent only once (during the Korean War) and averaged only 2.3 percent. If inflation was the price of activism in public economics, it was a long time in coming.

THE HAUNTED PROSPERITY OF THE 1980'S

Now, we have passed through the economic portals into the Eighties, the age of anti-government. Some of this actually began with that social liberal but fiscal conservative Jimmy Carter. I don't refer to deregulation of transportation, communication, and finance where competition has a fair chance to do well what regulation did badly. Nor do I refer to the harnessing, where possible—that is without sacrificing public purpose and values—of market incentives, the profit motive, private self-interest to the accomplishment of public purpose. Using taxes or auction rights to make depollution profitable and pollution costly is a case in point. But I do refer to sluffing off functions and responsibilities on grounds that delivery of the services has been inefficient in the past or on grounds that there is an inevitable too-costly clash between efficiency and equity.

But I digress from the subject at hand, which I designate as our haunted prosperity of the 1980's, a perceptive term borrowed from Al Sommers, of the Conference Board. Exactly what is it that haunts our prosperity in this new era of belittled government? The answer is sobering.

First, it is slow growth. After enjoying 4.2 percent annual real growth in the Sixties, and managing to average 3.1 percent even in the Seventies, we have slipped to less than 2 percent in the first six years of the Eighties. Even if we optimistically assume that there will be no recession in the next four years and an average 3 percent growth rate, the decade would come out with just a 2.4 percent real growth rate. And even if we adjust these numbers for the slowdown in the growth of the labor force, the Eighties as a whole seem destined to go into the economic annals as a period of pallid performance.

Second, we are haunted by resurgent poverty. The percentage of our population in poverty jumped from 12 percent in 1979 to 15.3 percent in 1983. Recovery brought the poverty rate down to 14.4 percent in 1984 but leaving aside the Reagan years, this is still the highest rate since 1966. It is worth noting that without cash transfers by the government, the poverty rate would be 25 percent and that with non-cash transfers like food stamps, the rate comes down to 9 percent. But even that is almost a 50 percent jump in povery since the late Seventies. The tax and budget cuts of the Eighties undercut the incomes of the poor, and boosted the incomes of the wealthy. The tax reform proposal, embodying more generous earned income credits, standard deductions, and personal exemptions, would be a welcome first step in reversing this doleful story.

Third, we are haunted by wasted potential. With the unemployment rate, after 5 years, still stuck at about 7% and utilization of our manufacturing capacity stuck at 80 percent throughout the third year of expansion, we are wasting a big chunk of our productive capacity, presumably as a means of safeguarding the great and welcome gains that have been made on the inflation front.

Fourth, productivity advances have fallen far short of expectations. A respectable performance in manufacturing has been more than offset by disappointing productivity gains elsewhere in the economy.

Casually correlated, with this change for the worse in growth, poverty, and wasted potential are some other economic changes that haunt us.

From 1950 through 1979, the Federal deficit averaged less than 1 percent of GNP. Now, the dificit is stuck at more than 5 percent of GNP, most of it structural rather than cyclical.

The huge deficits and high interest rates have spawned an over-valued dollar and enormous trade deficits. From roughly $25 billion in the late 1970's, readily financed by a flow of earnings from overseas investments the trade deficit zoomed to nearly $150 billion, with no offset from service earnings because we have become a net debtor nation. This dismal record on savings and investment is another concomitant of the huge budget deficit. Far from being in an investment boom, we have been on a consumer binge financed by liquidating our assets abroad, by gorging on a huge flow of imports, and by depressing national saving and investment to the lowest level since the 1930's. Since this runs counter to popular impression, let me cite chapter and verse. First, net private saving—individual plus business saving minus replacement investment—ran close to its long-run level of 8 percent to 9 percent of GNP in 1984. Second, half of it had to be used to finance the federal deficit with the result that the national saving rate fell from 8 percent to just over 4 percent. Third, only by sucking in huge amounts of foreign saving was net investment rate held at about 7 percent of GNP. But savings and investment by Americans have dropped to the lowest levels in fifty years.

Apart from such damning economic development, the Eighties have also seen the rise and fall of what Herb Stein aptly calls "punk-supply-sideism," to distinguish it from sensible classical supply-side policies for investment, productivity, and growth.

Alan Blinder put the matter well when he said, "Monetarists offered statistical evidence with no theory. New Classicists offered an elegant new theory with no evidence. Combining the best of both tactics, supply-siders offered neither theory nor evidence."

And that makes another point. With super-supply-sideism falling flat on its face, with monetarism failing to deliver, and with rational expectations, elegant as the theory is, proving to be a non-starter in the policy sweepstakes, Keynesians have regrouped, built Milton Friedman's natural rate of unemployment into their models, developed a credible theory of wage-price rigidities and regained the intellectual and policy-oriented high ground in economics. By being eclectic, pragmatic, and realistic, the Keynesians have made a remarkable comeback. (If you think I'm grinding a doctrinal axe now and then, you are right.)

WHERE DO WE GO FROM HERE?

Where should activistic economics go from here? There are plenty of new ideas floating around—and even a few good new ideas—but none will make much difference unless we restore the essential conditions for faster and more sustained economic growth and stop the consumption binge fostered by the irresponsible fiscal policies we have been following in the name of letting the private economy breathe free. What a travesty: the monstrous deficits generated in the name of breathing free are depriving the body economic of the oxygen essential to the growth of private saving and investment.

David Obey made the case for growth in eloquent terms this morning. I won't repeat it here. But it is worth reminding ourselves that it will take a skilled balancing act to put the economy back on the track of long-term growth while maintaining our expansionary momentum in the near term.

Clearly, the vital first step is to shrink the gigantic deficit that, to change the metaphor, is leeching the lifeblood out of growth by absorbing over half of our private savings. One has to hope that a Gramm-Rudmanized budget process will lead to a deficit disarmament conference and an agreement to couple tax increases with bearable budget cuts.

Second, even as we move fiscal policy toward restriction, we must maintain and even step up the level of aggregate demand in the economy. That's where the high-wire balancing act comes in, namely offsetting the reduction in aggregate demand from a more restrictive fiscal policy by running a more stimulative monetary policy. That in turn means keeping one eye on the substitution of investment for consumer spending as the budget deficits shrinks and interest rates fall and the other on the shift of demand from imported goods to domestically produced goods and services as the trade deficits shrinks. There is nothing in the market economy, left to itself, that will make the necessary adjustments.

Third, we will need to adjust our structural policies, applying the classical supply-side precepts designed to beef up our productive capacity and productivity—everything from boosting investment in physical infrastructure, in human brain power, and in research and innovation, to stimulating private saving and investment.

Lurking in the background of this whole process will be the personal trade-off question: Is an attempt to improve our growth and expansion performance going to reignite inflation?

What does past experience tell us about the need to curb our appetites for expansion and faster growth? Is it possible that we are mis-applying past experience, that we are like the cat that sat on a hot stove and now won't sit on a cold one? The tradeoff between unemployment and inflation may well have moved in our favor. With the hard core of inflation, namely, wage norms, coming down sharply, with plenty of excess capacity in the economy, and with these tendencies buttressed by falling oil prices and soft world commodity prices, isn't it time to test the waters with a more expansion- and growth-oriented policy as outlined above?

And since there's no guarantee that growth alone will reduce inequality—and worse, that with the incidence of poverty shifting so strongly to single-parent families and their children, there's no guarantee that growth will lift all the boats—isn't it about time that the richest country on earth (as we still are, in terms of both wealth per capita and annual goods and services per capita, according to the Kravis-Summers University of Pennsylvania studies), with the lowest taxes of any advanced country except Japan (and they are just a whisker behind us), and with the least socialized industrial economy on earth (as established by late seventies IMF data and a recent update by the London Economist), isn't it about time that we stopped asking the poor to take the main brunt of the build-up of our defenses?

And isn't it about time that we came out and said that it is a shameful thing to be gorging ourselves on imports and feasting on resources that ought really to be devoted to investment and growth, all in the name of hands-off economics and in the wake of irresponsible deficits and a White House that sees taxes, not as the price we pay for civilization, but as the root of almost all economic evil? And isn't it time to stop shortchanging the future by stunting growth and running up huge foreign debts in what Rudy Penner calls "fiscal child abuse"?

The fear and loathing of deficits in Congress is palpable. The JEC and the Congressional Budget Office have spearheaded the drive to bring some sanity into fiscal policy. Indeed the record shows—as Norman Ornstein's study for the AEI so clearly demonstrates that the Congress, as he put it, "thought the broad sweep of American history, Congress has struggled to restrain the growth of Federal spending and to limit deficits on the public debt, through direct action and through periodic adjustments of its own structures to minimize the deleterious effects of political pressures." He pays special tribute to the budget reforms of 1974, whose prime mover, Dick Bolling, we honor here tonight.

Thanks to courageous Congressional inititives led by Senators Dole and Domenici, in 1982 and by those two and others in 1983-84, with the President playing tag-along, the deficit is at least $100 billion a year less than it otherwise would have been.

So while there is much to be said for a brave new world of innovation in public economics—I will let others prescribe it—our first order of business is to clear the fiscal decks for action, promote growth with some farily orthodox measures, and use a modest portion of our vast wealth and taxable capacity to share more of our affluence with the poor and disadvantaged. That may be a bit old fashioned but show me something new-fashioned that would be better.

And this might just be the year when we will get on with it. Pursuing this thought, let me close with some words of hope with which Joseph Kraft ended one of his last columns: "Except in its blindest moments, the United States is not a country that sins against the light . . . Normally, on the contrary, the United States plays host to a humane society. Few things, certainly not the tyranny of abstract numbers, drive us to barbarous, even unfeeling behavior. So my hunch is, when all the figures come up on the table, when Gramm-Rudman is in its heaven; Americans will figure out a way to beat the odds. We will balance welfare and defense and investment and social improvement in a rough way that does not blight vast numbers of lives. Both in dealing with the Russians, and in dealing with ourselves, we will make good the promise of a turnaround year." Amen!

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